INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/205

REPUBLIC OF CROATIA

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CROATIA

September 2021

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with the Republic of Croatia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its August 30, 2021, consideration of the staff report that concluded the Article IV consultation with the Republic of Croatia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on August 30, 2021, following discussions that ended on June 21, 2021, with the officials of the Republic of Croatia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 29, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Croatia.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR21/258

IMF Executive Board Concludes 2021 Article IV Consultation with Croatia

FOR IMMEDIATE RELEASE

Washington, DC – **September 10, 2021:** On August 30, 2021 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Croatia.

The Croatian economy has been subjected to severe stress, but is showing its resilience. The pandemic and two devastating earthquakes led to a 8.0 percent drop in activity in 2020, reflecting lower domestic and external demand—particularly, a drop of some 60 percent in tourism receipts (yoy). Ample support of fiscal and monetary policy, coupled with appropriate relaxation of supervisory requirements, helped to contain the effects of the pandemic. The financial position of the government was somewhat alleviated by the EU funds (loans, transfers) that have financed most of the fiscal support measures. The CNB intervened in the currency market and mitigated tensions in the domestic bond market through purchases of government securities (about 5.5 percent of GDP). It also lowered reserve requirements and conducted repo operations. Markets calmed, not least after a €2 billion SWAP arrangement with the ECB was announced in mid-April 2020. External indicators held up relatively well, the current account posted a small 0.4 percent deficit in 2020, despite the collapse in tourism receipts. However, gross public and external debt climbed by almost 16 and 6 percentage points, respectively, causing a reversal of earlier gains. Inflation has remained benign, despite a recent uptick.

A robust bounce back is projected for 2021 and 2022, of 5.4 and 5.8 percent growth respectively driven by a rebound in the services sector (assuming ⅔ and nearly full recovery of tourist arrivals in 2021, and 2022 respectively), and investment which will be bolstered by large EU investment grants over the medium-term. Over the medium term, growth is projected to ease closer to 3 percent. Inflation is projected to pick up and stay at 2 percent through 2023, in line with the ECB inflation target. There are large risks on both sides, including from virus mutations in the near-term which could result in significant economic scarring. Medium-term growth would be substantially lower if the pace of recovery in EU trading partners is lower than expected, if EU funds are not effectively absorbed and/or if promised complementary reforms remain challenging to deliver. On the upside, a more rapid and successful vaccination campaign would enable a quicker return to the health of the population and the economy. Over the medium-term, the positive effects of green investments and digitalization may be greater than projected.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors welcomed the swift measures taken to combat the COVID-19 pandemic thus building the foundations for the projected recovery, underpinned by tourism and investment.

Directors welcomed the authorities' efforts to balance the pandemic recovery with fiscal prudence while remaining vigilant to support the nascent recovery as needed. They stressed that it will be important to avoid further tax cuts to conserve fiscal resources and to firmly place public debt levels on a downward trajectory over the medium term.

Directors called for an accelerated implementation of structural reforms and the need to increase the capacity to absorb EU structural funds, in particular in the area of public investment management. Such reforms are essential to make progress toward the goal of closing the income gap to the EU average and to achieve the desired decarbonization, digitalization, and diversification of the economy. In this context, they also welcomed the authorities' plans to implement a civil service remuneration system that rewards productivity, as well as the merging of healthcare services across sub-national governments.

Directors considered that monetary policy had been appropriately accommodative within the limits of the exchange rate anchor and ample global liquidity. They welcomed ERM II membership in July 2020, in the context of the authorities' strategic priority of euro adoption. Noting the benefits of euro adoption, Directors welcomed the authorities' strong commitment to observe the convergence criteria and to improve the AML/CFT framework and SOE governance.

Directors stressed the need to remain vigilant to financial and banking sector risks with the expiration of the regulatory easing introduced in line with the European Banking Authority guidelines to mitigate the impact of the pandemic. They welcomed the decision to facilitate write-offs of NPLs and efforts to strengthen the insolvency framework. Directors urged the authorities to remain particularly vigilant over credit developments in the real estate market and stand ready to absorb excess liquidity and impose adequate macroprudential measures if needed.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Croatia: Selected Economic Indicators, 2016-26

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
								Proj.			
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)										
Real GDP growth	3.5	3.4	2.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1
Contributions:											
Domestic demand	3.2	4.2	4.6	2.7	-2.3	3.9	6.5	4.9	3.1	1.7	1.7
Net exports	0.3	-0.7	-1.9	0.2	-5.8	1.5	-0.7	-0.9	0.2	1.5	1.4
Unemployment	15.0	12.4	9.9	7.8	9.0	8.5	8.0	7.7	7.2	7.0	6.8
CPI inflation (avg.)	-1.1	1.1	1.5	0.8	0.1	1.8	1.9	2.0	2.0	2.0	2.0
Saving and investment (percent of GDP)											
Domestic investment	21.0	22.0	23.4	22.6	25.6	26.4	27.2	28.0	28.5	27.6	27.0
Domestic saving	23.2	25.5	25.3	25.7	25.3	25.8	25.9	26.8	27.7	27.2	26.8
Government	3.5	4.4	5.0	5.7	-1.1	1.4	2.6	3.5	4.3	4.9	5.1
Nongovernment	19.7	21.1	20.2	20.0	26.3	24.4	23.4	23.2	23.4	22.3	21.7
Government Sector (ESA 2010 definition)											
General government revenue	46.5	46.0	46.2	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
General government expenditure	47.4	45.2	46.0	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
General government balance	-1.0	0.8	0.2	0.4	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Structural balance 1/	-1.0	0.8	1.5	0.5	-5.7	-3.2	-2.6	-1.8	-1.1	-0.5	-0.4
General government debt 2/	80.8	77.5	74.2	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
Balance of payments (percent of GDP)											
Current account balance	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Capital and financial account	-2.3	1.5	0.8	-1.0	2.4	7.0	4.3	3.6	2.0	0.9	0.5
FDI, net	4.3	2.3	1.6	6.3	1.6	1.9	1.8	1.8	1.8	1.8	1.8
Debt and reserves											
Gross official reserves (billions of euros)	13.5	15.7	17.4	18.6	18.9	22.3	24.0	25.4	26.1	26.4	26.6
IMF metric (percent) 3/	88.5	102.0	112.4	103.4	125.6	138.9	143.2	147.2	146.9	145.7	144.4
In months of imports in goods and services (based on next year level)	7.5	7.8	7.9	7.9	9.3	9.7	8.8	8.6	8.3	8.0	7.6
Total external debt (percent of GDP)	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
Money and credit	(End of period, change in percent)										
Broad money (M4)	4.7	2.1	5.5	2.9	9.3	7.0	5.0	4.5	4.0	4.0	4.0
Claims on other domestic sectors 4/	-3.4	-0.8	1.8	2.6	3.3	--	--	--	--	--	--
Interest rates											
Average 12-month T-bill interest rate (in kuna)	1.0	0.4	0.1	0.1	0.1	--	--	--	--	--	--
Kuna credit rate (unindexed, outstanding amount)	6.5	6.0	5.7	5.2	4.8	--	--	--	--	--	--
Exchange rate											
Kuna per euro	7.6	7.5	7.4	7.4	7.5	--	--	--	--	--	--
Real effective exchange rate (percent, "-" = appreciation)	0.3	0.7	1.9	-1.4	--	--	--	--	--	--	--
Memorandum items:											
Nominal GDP (billions of euros)	46.6	49.3	52.0	54.3	49.3	52.4	56.2	59.8	63.0	66.0	69.1

Sources: Croatian authorities; and IMF staff estimates. Unemployment rate is from Croatian Bureau of Statistics and Haver Analytics.

1/ Based on a simplified approach to the cyclically-adjusted balance, in percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015. The 2020 overall budget balance (-7.4 percent of GDP) minus the cyclical component (-1.7 percent of GDP) results in a cyclically adjusted budget balance of -5.7 percent of GDP. Includes the one-offs related to the COVID-19 package of -3.8 percent of GDP. For 2021, the overall budget balance (-4.1 percent of GDP) minus the cyclical component (-0.9 percent of GDP) results in a cyclically adjusted budget balance of -3.2 percent of GDP. Includes the one-offs related to the COVID-19 package of -2.5 percent of GDP.

2/ Gross debt as defined by the EU under the Maastricht Treaty.

3/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.

4/ Comprises claims on households and non-financial corporations.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

July 27, 2021

KEY ISSUES

Context: As other emerging economies reliant on tourism (about 25 percent total contribution of tourism-related industries in GDP and employment), Croatia has been hit hard by the pandemic and two devastating earthquakes, leading the economy to contract by 8.0 percent in 2020. Vaccinations have been rolled out to about 38 percent of the population (end-June 2021). Staff projects growth to bounce back to 5.4 percent in 2021, driven by a rebound in the services sector and investment, aided by fiscal and monetary policies, and bolstered by large EU grants over the medium-term.

Policies:

- **Rebuild resilient and sustainable tourism:** Near term, policies should focus on still-affected businesses and workers. Policies that foster the green and digital transition of existing public tourism infrastructure, the development of tourism beyond established destinations will help reduce scarring and rebuild sustainable tourism.

- **Balance short term support with medium-term discipline:** Once the recovery is on a firm footing, fiscal deficits and the public debt need to resume their pre-pandemic downward trajectory. Successful absorption of substantial forthcoming EU funds accompanied by full implementation of reforms promised under the latest National Recovery and Resilience Plan (NRRP), as well as by strengthening public investment management, are essential to facilitate higher growth, and to lower debt.

- **Anchor stability through exchange rate, monetary, and financial policies: The highly** expansionary monetary stance, within the exchange rate anchor and ample global liquidity, has been appropriate for the pandemic. Supervisory vigilance should be continued. Efforts to facilitate more efficient debt restructuring should be furthered.

Approved By
Jörg Decressin (EUR) and Martin Sommer (SPR)

Virtual discussions were held from June 7–18, 2021. The team comprised Mr. Seshadri (head), Mses. Bunda and B. Li, and Mr. Lybek (all EUR). Mr. Milutinović (OED) joined several meetings. Mses. Zhang and Gonzales (EUR) assisted in the preparation of this report. The staff team met with Deputy Prime Minister and Minister of Finance Mr. Marić, the Governor of the Croatian National Bank Mr. Vujčić, the Fiscal Policy Committee of the Parliament; officials from key economic ministries, and representatives of the business community, banks, think-tanks, and academia.

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CONTEXT

1. Croatia (HRV) has been hit hard by the pandemic and two severe earthquakes in 2020. The 8.0 percent real GDP decline in 2020 reflects lower domestic and external demand—particularly, a drop of some 60 percent in tourism receipts (year-on-year). Ample support of fiscal and monetary policy, coupled with appropriate relaxation of supervisory requirements, helped to contain the effects of the pandemic. Some 40 percent of the population was vaccinated with at least one shot as of July 2021.

2. ERM II membership commenced on July 10, 2020. It is a critical step toward the authorities' aspiration to adopt the euro.[1] The Croatian National Bank (CNB) and the European Central Bank (ECB) also established close cooperation on banking supervision effective October 2020.[2]

3. Next Gen EU Funds, if effectively utilized, represent a unique opportunity. Totaling some 11 percent of GDP over the next six years, these funds are substantial, since they will double the amount that Croatia has been receiving through regular EU Multiannual Financial Framework funds. They would allow for higher investment in green infrastructure, education and skills of the workforce, and technological advancements that substantially improve medium-term growth, whilst reducing fiscal risks and narrowing the per capita income gap with respect to the EU average (Box 2).

RECENT DEVELOPMENTS

4. The effects of the 2020 contraction were widespread. They were manifested by large drops in personal consumption (-6.2 percent, yoy) and private investment (-9.5 percent, yoy). Job preservation measures prevented a significant rise in unemployment (averaging 9 percent in 2020, compared with 7.8 percent in 2019) and supported household incomes. Net exports contracted by 8.1 percent in 2020 following the unprecedented sudden stop of international tourism (exports and imports plummeted by 25 percent and 14 percent, respectively).

5. Output grew strongly in 2021:Q1. Exceeding expectations (5.8 percent qoq and -0.9 percent yoy, SA), growth was driven by merchandise exports and investment. High-frequency second quarter data (car and retail sales, fiscalized receipts) indicate consumption is rapidly catching up. Industries like construction, manufacturing, and ICT have already reached or exceeded pre-pandemic levels. Tourism and others dependent on it (e.g., food and transport) are understandably the key laggards, where there is the most potential for scarring.

[1] A Eurobarometer survey conducted in May 2021 found that 61 percent of Croatians were in favor and 37 percent against euro adoption.

[2] The CNB joined the Single Supervisory Mechanism (SSM). The ECB thereby supervises eight significant banks, while the CNB supervises the rest on behalf of the ECB. The CNB continues to formulate and implement macroprudential policy in collaboration with the ECB. Croatia also participates in the Single Resolution Mechanism (SRM).

6. The pandemic has caused earlier fiscal gains to reverse. Following an 8-percentage point of GDP decline from 2016–19, public debt once again shot up to 88.7 percent of GDP and the budget deficit to 7.4 percent of GDP in 2020 (Figure 1). However, staff estimates the structural deficit excluding Covid-19 measures at 1.9 percent of GDP. The financial position of the government was alleviated by the EU funds (loans, transfers) that have financed most of the fiscal support measures (e.g., short-term work scheme financed via SURE). Yields on government bonds following the outbreak of the pandemic have generally returned to pre-pandemic levels[3].

7. External indicators held up relatively well, in 2020. The current account deficit was small (0.4 percent of GDP) in 2020. The collapse in tourism receipts offset the decline in goods imports and the increase of net investment income inflows. Official reserves are above the ARA metric. However, gross external debt climbed by some 6 percentage points, to 81.3 percent of GDP in 2020 (Figure 2, Annex III). Overall, the external position in 2020 was broadly in line with the level implied by fundamentals and desirable policies (Annex IV. External Sector Assessment). The SDR allocation in August 2021 is expected to increase reserves slightly.

8. The CNB swiftly implemented measures to counter the Covid-19 shock. The CNB intervened in the currency market (about €2.7 billion, 5.5 percent of GDP), and mitigated tensions in the domestic bond market through purchases of government securities (about 5.5 percent of GDP). It also lowered reserve requirements and conducted repo operations (Annex IX). Markets calmed, not least after a €2 billion SWAP arrangement with the ECB was announced in mid-April 2020. The CNB has since conducted a few modest FX interventions on both sides of the market.[4]

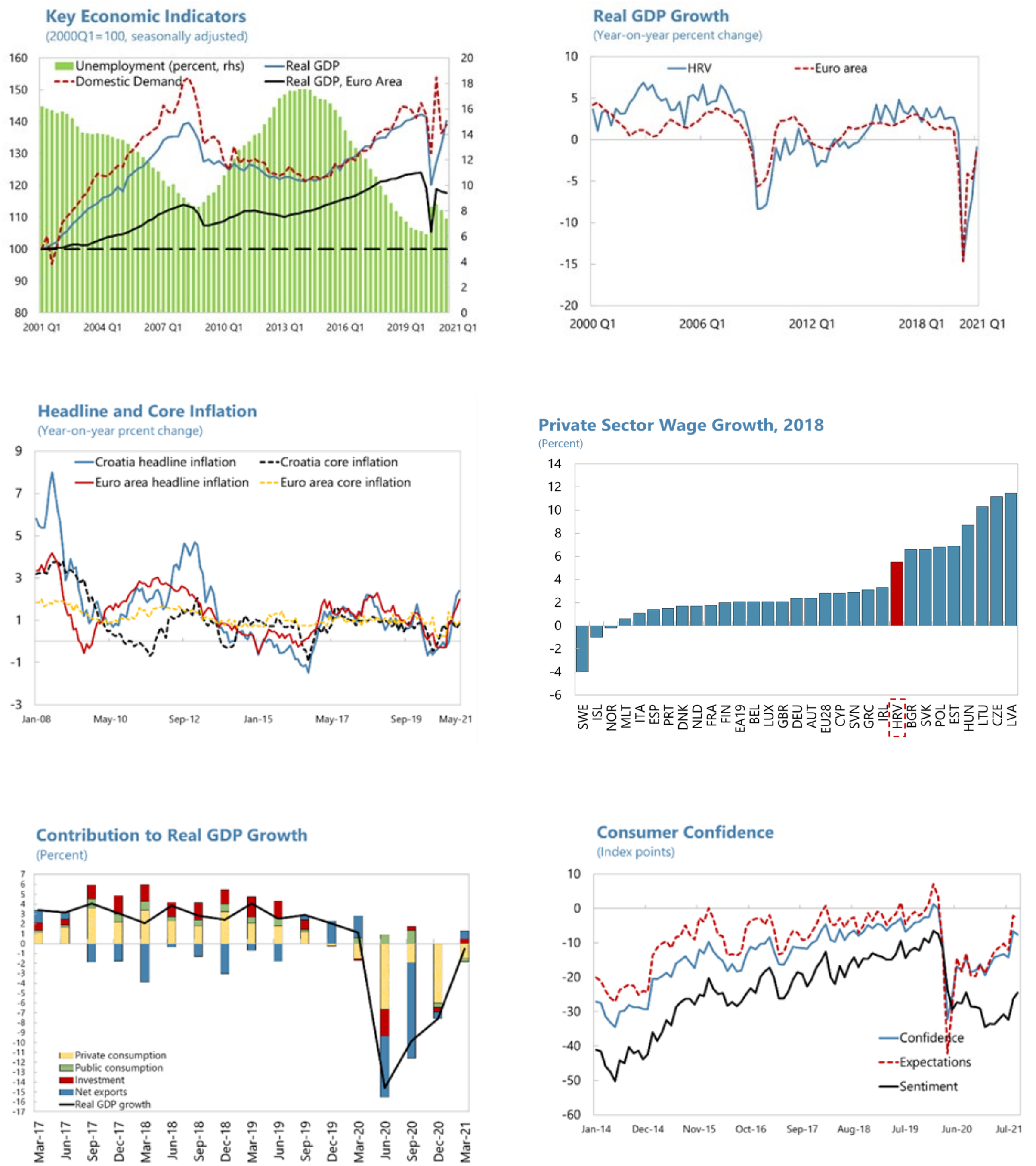
9. Inflation has remained benign, despite a recent uptick. Headline inflation (2.1 percent in April and May, but eased to 2.0 percent in June 2021, y-o-y), has been driven by energy prices and excises. Thus far during 2021, core inflation has hovered around 0.5 percent (y-o-y). Producer prices have increased swiftly in 2021 (7.2 percent in June 2021, compared to negative territory last year), likely reflecting temporary recovery bottlenecks, in addition to energy prices.

10. Overall bank lending remained firm. Initially, bank credit growth to non-financial corporations (NFCs) was solid but has recently leveled off. Lending growth to households (stocks), has decelerated (2.7 percent in May 2021, y-o-y). Uncollateralized general-purpose cash loans declined, while lending for housing has remained strong. An optional debt-service moratorium was introduced, consistent with EBA guidelines. NFCs have accounted for most of the moratoria compared to households (17 and 3 percent of total NFC and household loans, respectively, end-2020), but have since further declined. Foreclosures were temporarily paused from mid-April to mid-October. The Croatian Bank for Reconstruction and Development (HBOR) and the Croatian Agency of SMEs, Innovations and Investment (HAMAG-BICRO) offered special Covid loans and guarantees to help companies affected by the pandemic (about 0.7 percent of GDP at end-2020).

[3] Stable sovereign risk premium and credit rating facilitated government borrowing in 2020 and in early 2021.

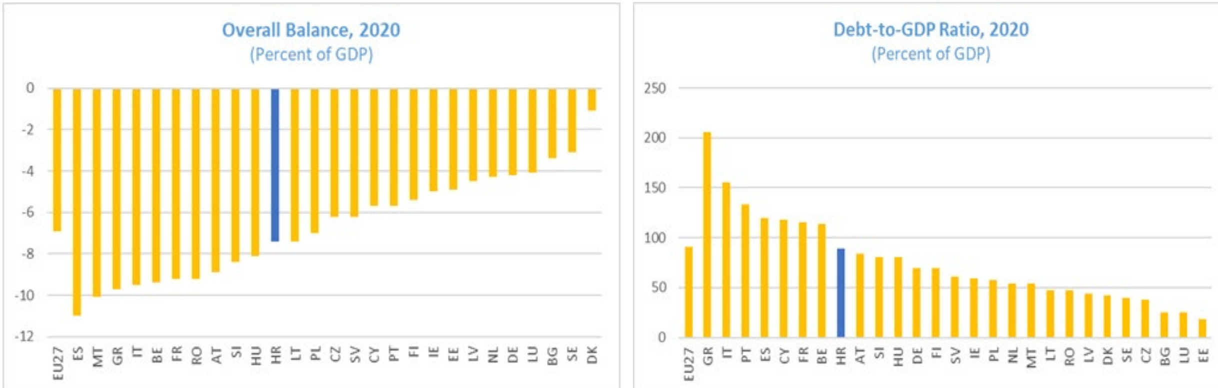
[4] Regarding expected SDR allocation, please see footnote 6.

Figure 1. Selected Real Sector Indicators



Sources: Croatian National Bank, Croatian Bureau of Statistics/Haver Analytics; Eurostat; and IMF staff calculations.

Figure 2. Fiscal Sector Indicators

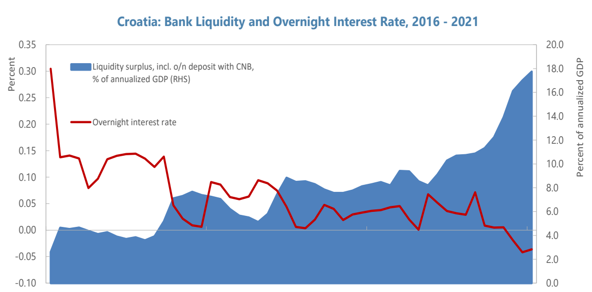


Sources: Eurostat; and IMF staff calculations

11. The banking system retained comfortable buffers. At end-2020, the capital adequacy ratio (CAR) was around 25 percent. (The two banks with lowest CAR, had ratios above 14.0 percent.) This was helped by changes in prudential regulation (mainly, prohibited dividend distribution and lower risk-weights on FX denominated claims on sovereign debt) and increased lending to the government. All banks remained very liquid with comfortable liquidity coverage ratios well over the regulatory minimum. Bank profitability more than halved in 2020, but only 4 of the 23 credit institutions reported losses. The stability of the NPL ratio in 2020 (around 7 percent, FSI definition), was mainly due to the flexible interpretation of IFRS 9 (as part of Covid-19 measures aligned with EBA guidance) and NPL sales. The reactivation of the credit registry in mid-2020, after a General Data Protection Regulation (GDPR) induced pause, helped banks' risk management.[5]

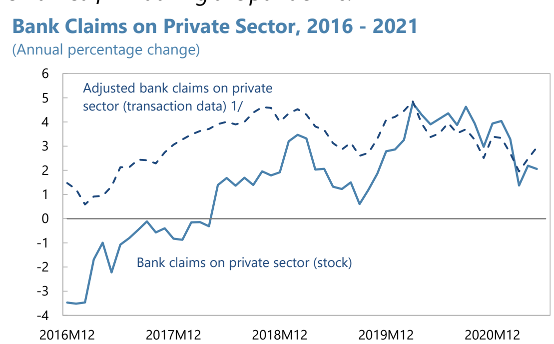
Figure 3. Monetary Stance and Bank Lending to the Private Sector, 2016–2021

The monetary stance has been highly expansionary while maintaining exchange rate stability.



Source: Croatian National Bank.
Note 1: Liquidity surplus is the difference between the balance in bank settlement accounts with the CNB and the amount the banks are required to hold in their account after the calculation of reserve requirements.
Note 2: The interest rate refers to the overnight demand deposit trading.
Note 3: Annualized GDP is 12 months cumulated GDP of quarterly GDP split equally into month.

Bank lending to the private sector, particularly households, remained firm during the pandemic.



Sources: Croatian National Bank and IMF staff estimates.
Note: Claims on private sector include claims on households, non-financial corporations, and local governments.
1/ Dotted line based on transaction data, i.e. adjusted for exchange rate changes, sales and write-offs of NPLs. For details, see Annex 1 in *CNB Monthly Bulletin No. 221*, February 2016, Croatian National Bank.

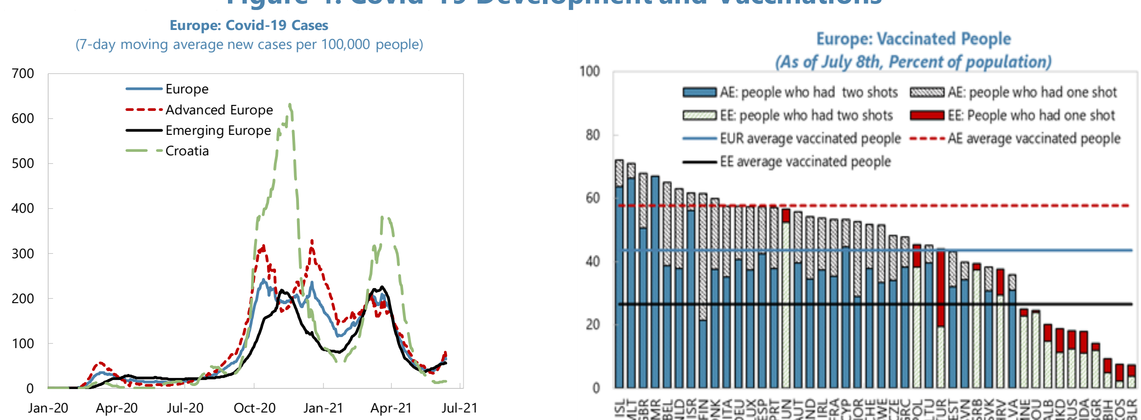
[5] After May 2018, banks suspended the exchange of information in the Croatian Registry of Credit Obligations (HROK), due to concerns of some banks about the legal implication of the transposition of the GDPR. In August 2019, banks began to exchange information about defaulting clients. In June 2020, following amendments of Credit Institutions Act, more detailed information was again shared in the new Basic Register System (OSR), which is also owned and operated by the Croatian Banking Association. Thus far, leasing companies only share information about legal persons, but not about natural person due to concerns about the legal implications of GDPR.

OUTLOOK AND RISKS

12. Growth is projected to rebound to 5.4 percent in 2021, driven by tourism and domestic demand.[6] Real GDP is projected to reach 2019 levels by end-2022, assuming ⅔ and nearly full recovery of tourist arrivals in 2021, and 2022 respectively. Tourism assumptions are driven primarily by recovery and vaccination paths of Croatia, and its main tourism source countries. Domestic demand is projected to contribute 3.9 percent to real GDP growth. Output projected in 2022 is still 4.8 percent below pre-pandemic projections, reflecting possible scarring in tourism and related sectors. Inflation is projected to stay at 2 percent through 2023, in line with the ECB inflation target.

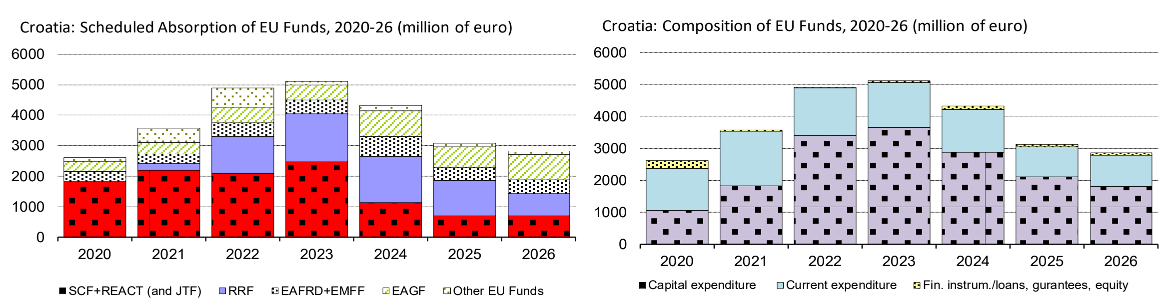
13. Medium-term growth will depend on the recovery of tourism and EU funds (Figures 4, and 5). Public investment will be supported by EU-funded projects, including through the Next Generation EU (NGEU) funds and the EU 2021–27 multiannual budget for a total exceeding 1/3 of GDP over the next six years). A moderate pickup in absorption of EU structural funds is expected based on current trends, while for NGEU grants full utilization is assumed by 2026. The difference between the latest and pre-pandemic GDP projections is estimated to narrow to about 2 percent by 2026.

Figure 4. Covid-19 Development and Vaccinations



Sources: Bloomberg Finance L.P.; IMF, *WEO*; and IMF staff calculations.

Figure 5. Actual and Expected EU Funds



Sources: Croatian authorities and IMF staff calculations

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[6] The baseline is contingent on the Board of Governors' approval of the SDR allocation, expected mid-August 2021. For Croatia, it amounts to about US$ 0.980 billion. The authorities do not intend to use the allocation. A non-allocation of SDR will not materially affect the baseline, other than by a commensurately lower level of gross international reserves.

14. Risks to the baseline abound on both sides, amid unusually high uncertainty.

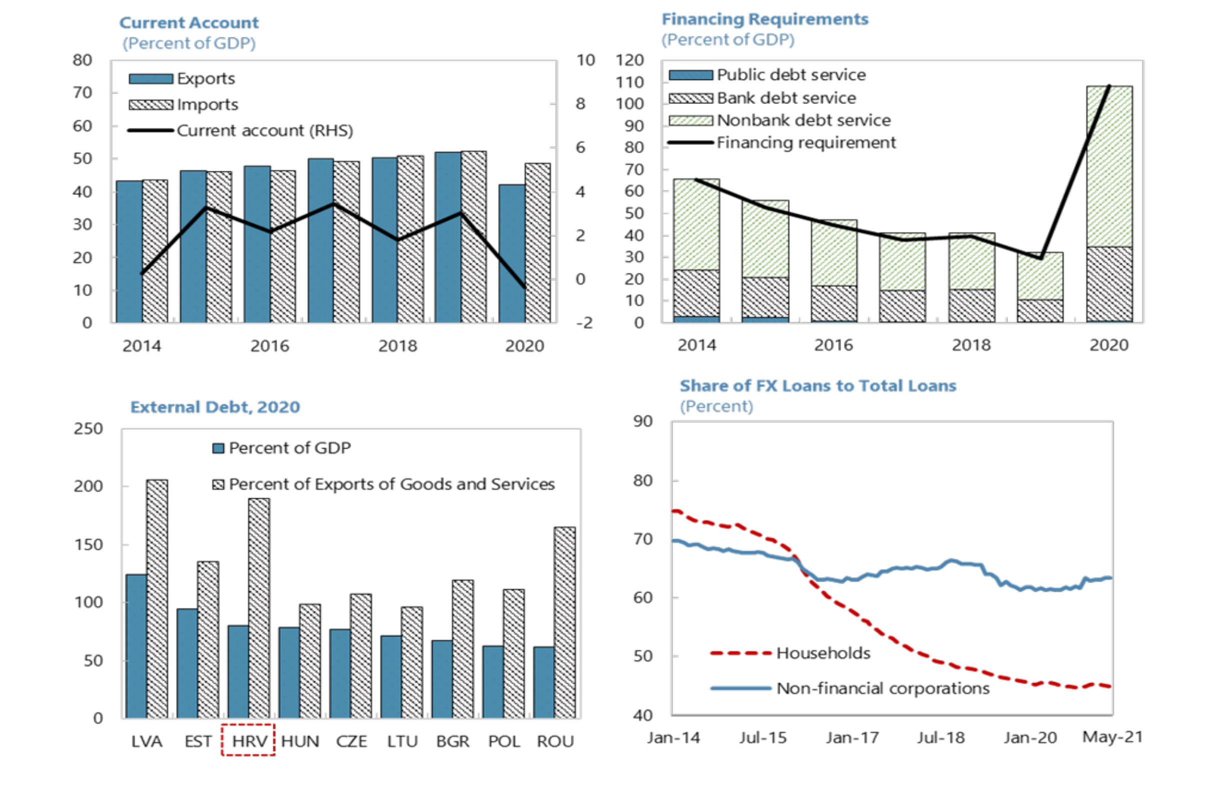
- On the ***upside*** faster vaccination rollouts, could boost short-term activity. Over the medium term, higher public investment could have stronger than projected effects on growth.

- On the ***downside,*** adverse shifts in the pandemic, and consequent effects on tourism dominate. Risks from further realization of contingent liabilities (mainly related to healthcare arrears) and rising commodity prices cannot be discarded. Medium-term growth could be substantially lower if EU funds are not effectively absorbed and/or if promised complementary reforms remain challenging to deliver. Higher frequency and severity of natural disasters related to climate change could hit key infrastructure or disrupt trade. Public and private debt remain sensitive to GDP growth and interest rate risks (Annex II-III).

Authorities' Views

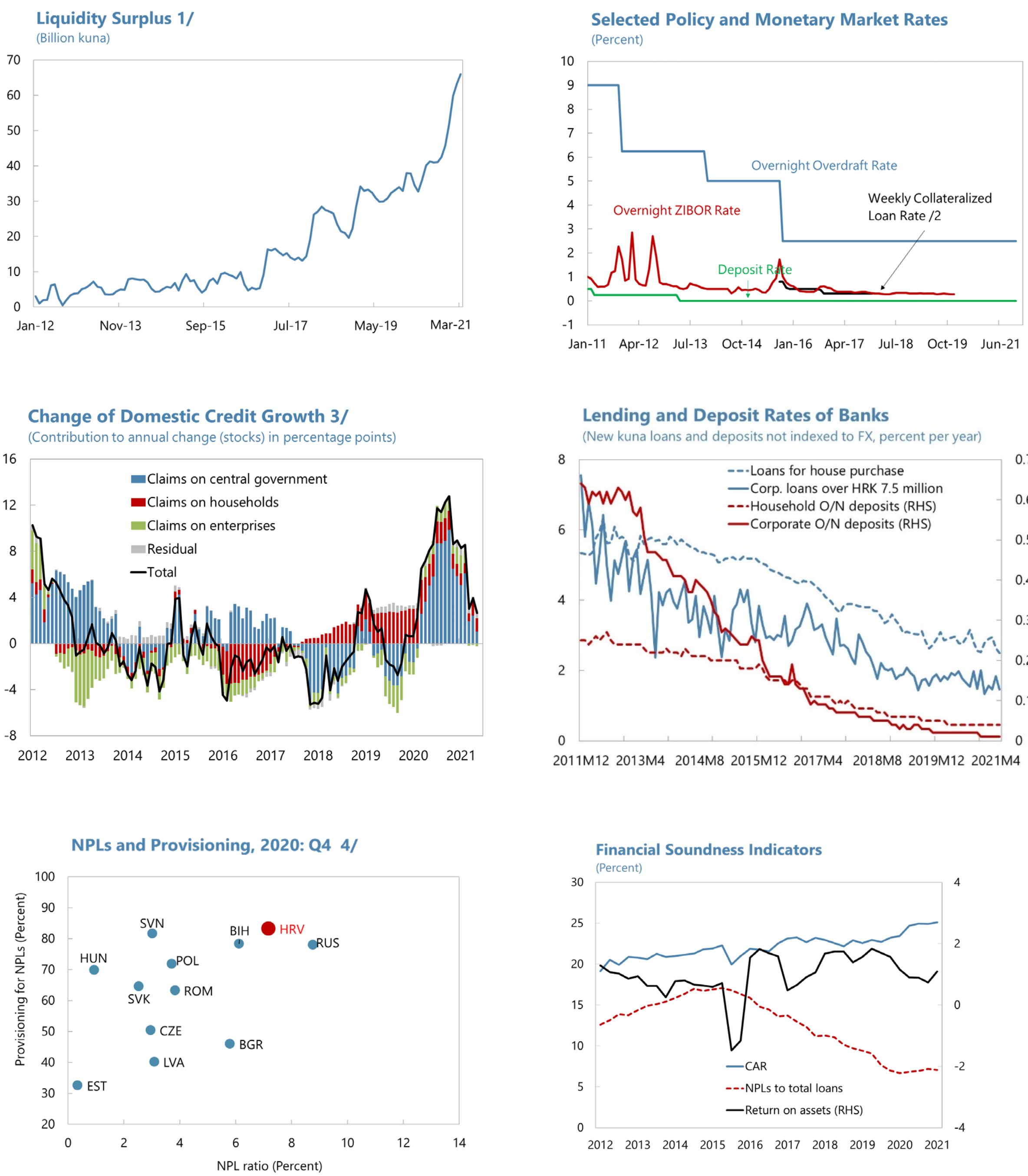
15. The authorities project a slightly higher growth path over 2021–23 than staff. They are optimistic about medium-term demographic, labor, and emigration trends, in tandem with their confidence in a delivering challenging reforms now included in the NRRP (Annex VII). They agreed that support measures must remain in place for lagging sectors for as long as needed. The authorities believe that most of the legacy contingent liabilities (financial sector, SOEs, healthcare) have already been addressed, and the application rate for moratorium related guarantees was low.

Figure 6. Short-Term Vulnerability Indicators



Sources: Croatian National Bank; IMF, *World Economic Outlook*; and IMF staff estimates.

Figure 7. Banking Sector Developments



Sources: National Bank of Croatia; and IMF staff estimates and calculations.

1/ Liquidity surplus is the difference between the balance in bank settlement accounts with the CNB and the amount that banks are required to hold in their accounts after the calculation of reserve requirement.

2/ Reverse repo re-introduced in 2015, mainly due to mandated retroactive conversion of Swiss franc-indexed household loans into euros.

3/ Change in stock of domestic credit from monetary survey.

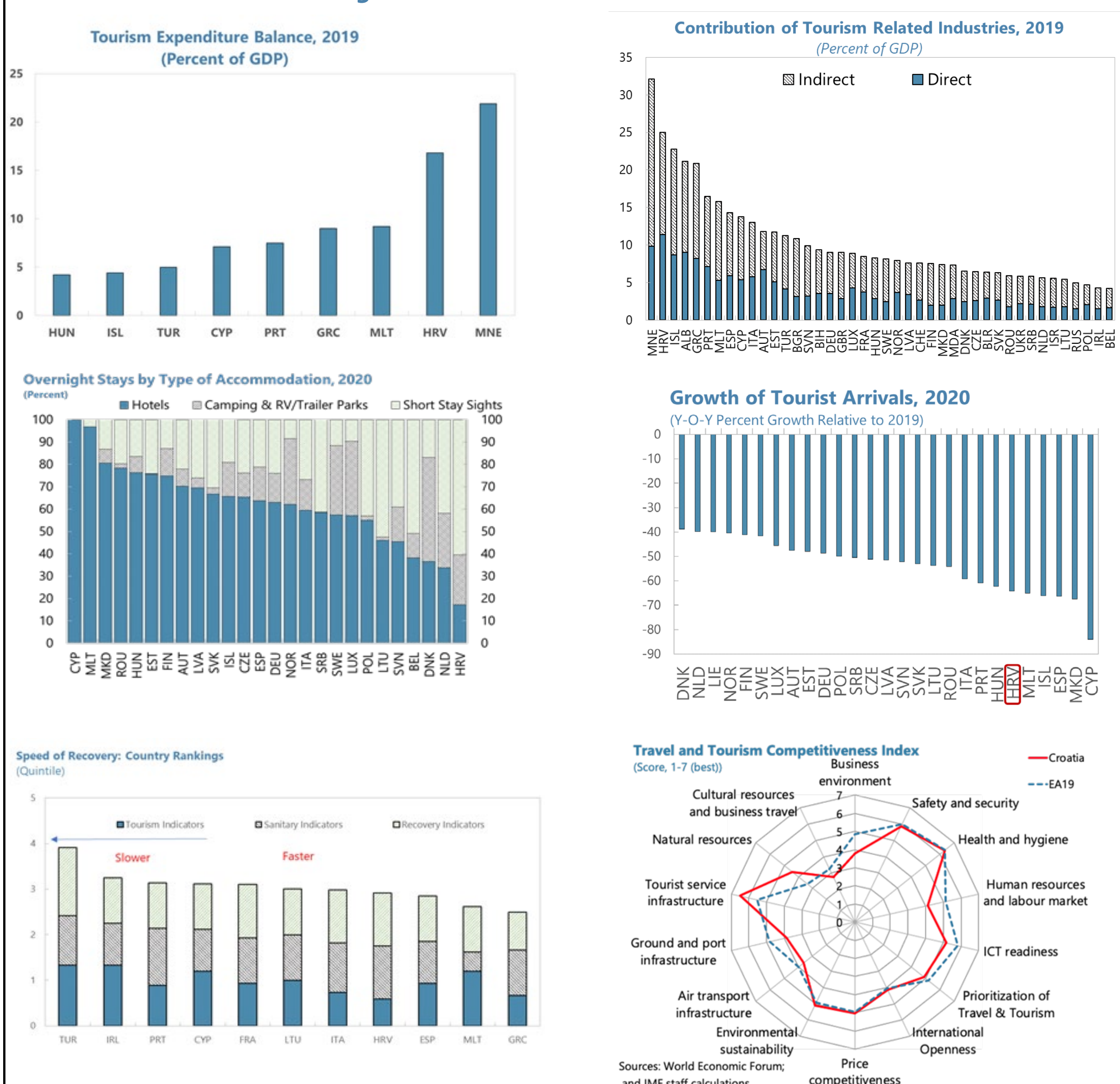
4/ According to FSI data. Impairment in percent of NPLs (national definition) is around 64 percent.

POLICY DISCUSSIONS

A. Rebuild Sustainable Tourism

16. Croatian tourism has unique advantages that could aid a fast recovery. The country's geographical location gives it ease of accessibility from key EU source countries. Croatia hopes to join the Schengen area as early as next year. Furthermore, the country's excellent road networks make it less dependent on airline travel. Other factors such as less reliance on hotels, and more private accommodation broadly spread beyond large urban areas also bode well for a recovery (Figure 8). Still, given the potential for scarring, it is important to implement a range of policies to ensure sustainable and resilient tourism in the aftermath of the pandemic (Annex VI).

Figure 8. Tourism Sector Characteristics



Sources: Eurostat, Haver Analytics, and IMF staff calculations

Authorities' Views

17. The authorities project a slightly faster tourism recovery than staff. They hope for a strong and extended season this year, aided by the current epidemiological situation and their innovative use of travel policy (e.g. vaccine passports). They estimate that over 70 percent of tourism industry personnel are vaccinated. The Tourism Ministry agreed with staff on medium-term development strategies, emphasizing new planned facilities in relatively underdeveloped regions.

B. Fiscal Policy: Short-Term Support and Medium-Term Discipline

18. The government's medium-term fiscal plan appears ambitious.[7] The Budgetary Plan for 2021 aims to reduce the deficit quickly. The wage bill, and social benefits are targeted to converge to 2019 levels (as a share of GDP) by 2024 (text table 1) with help from the structural reforms included in the NRRP. Although revenue assumptions seem broadly appropriate, the expenditure objective may be tight given the rigidity in the budget (text table 3). Staff projects slightly higher expenditure for 2021–22 than the April 2021 budgetary plan (Table 3).

Text Table 1. 2021 Budgetary Plan

in % of GDP	2019	2020	2021f	2022f	2023f	2024f
Total revenues	**47.5**	**48.0**	**50.5**	**51**	**50.5**	**48.9**
Indirect taxes	20.2	19.0	19.6	20.1	20	20
Direct taxes	6.6	6.7	6	5.7	5.7	5.6
Social contributions	11.8	12.1	12.5	12.1	12	12
Other revenues	8.9	10.2	12.4	13.1	12.8	11.3
Total expenditures	**47.2**	**55.4**	**54.3**	**53.6**	**52.4**	**50.5**
Compensation of employees	11.9	13.6	13.6	13.1	12.8	12.6
Intermediate consumption	8.4	8.7	8.8	8.6	8.5	8.5
Social benefits	15.5	17.4	16.8	16.0	15.5	15.2
Interest	2.2	2.0	1.8	1.6	1.3	1.0
Subsidies	1.5	3.8	2.8	1.6	1.6	1.5
Investment	4.3	5.6	6.1	7.5	7.1	6.6
Capital transfers	1.9	2.0	2.2	2.7	3.2	2.8
Other	1.5	2.3	2.3	2.5	2.4	2.4
General government balance	**0.3**	**-7.4**	**-3.8**	**-2.6**	**-1.9**	**-1.6**
General government debt	**72.8**	**88.7**	**86.6**	**82.5**	**79.5**	**76.8**

Source: MoF, as of April 2021

Expenditures

19. As a recovery takes hold, support measures are phasing out (Text table 2). Staff estimates that the cyclically adjusted fiscal deficit will fall by 2.5 percentage points of GDP in 2021, from 5.7 percent of GDP in 2020. The authorities have committed to some measures from 2020 being continued, while more targeted measures have been added since end-2020.[8] The measures in continuation this year are: (i) short-term work schemes (and job retention programs), until end-June 2021 in their initial format and going forward, with modified eligibility;[9] (ii) grants to business in affected sectors; (iii) pension supplement; (iv) other pandemic-related spending (healthcare,

[7] In the 2022–2024 Convergence Program the government expects real GDP growth of 5.2 percent in 2021, 6.6 percent in 2022, 4.1 percent in 2023 and 3.4 percent in 2024.

[8] From a transparency perspective, the State Audit Office of Croatia routinely audits the execution of the budget. The Annual Report for 2020 was adopted by the parliament on June 2, 2021. According to the Chief Auditor, the most important challenges are rebuilding from the earthquakes and absorbing EU funds. The forthcoming PIMA mission will provide an opportunity for staff to gain in-depth knowledge of public procurement laws. This will help inform deeper analysis of spending governance in the next Article IV Consultation when public expenditures would begin to ramp up at a more rapid pace and over several more years, relative to pandemic spending.

[9] Currently, linking the payment of job preservation subsidies for the month of July to vaccinations (Covid-19 passes/certificates) is under discussion.

vaccines); and (v) deferral of social contributions. Tax deferrals and relief measures have been discontinued. New measures include targeted support to the tourism sector (training targeted to immediate market needs, subsidies to tourism agencies) as well as new guarantee programs for corporates, financed via from the European Guarantee Fund (EGF) set up by the EIB Group in 2020 to accelerate the post-pandemic recovery of European economies.[10] Some policies announced to support demand were modified at end-2020 (overhead costs to firms with min. 40–60 percent m-o-m drop in income) and are still in place. Staff projects a slightly higher fiscal deficit as a share of GDP this year primarily due to differences in growth assumptions in the baseline. Staff views that a higher deficit in 2021 due to adverse growth surprises should be fully accommodated. The country is well-perceived in credit markets and should be able to finance any needed extra spending through debt.

Text Table 2. Fiscal Support Measures in the Budget in Response to the Pandemic, 2020–21

List of measures		Fiscal effects, HRK million	Fiscal effects, % GDP
COVID-19 MEASURES IN 2020	**Write-offs of direct taxes and contributions**		
	personal income tax	115.296	0.0%
	pension and healthcare insurance contribution	2884.219	0.8%
	corporate income tax	85.734	0.0%
	COVID related subsidies to sectors of agriculture, transport, culture, sports and tourism	347.807	0.1%
	Subsidies to preserve employment	7325.618 382.73	2.1%
	Remuneration due to temporary incapacity for work	111.712	0.0%
	Social transfers in kind in health sector	515	0.1%
	Reimbursement of fixed costs	10350.0%	0.0%
	Capital injections treated as capital transfer to Croatia Airlines	600	0.2%
	Acquisition of medical and protective equipment to combat COVID-19	1737.813	0.5%
	TOTAL FISCAL EFFECTS OF COVID-19 MEASURES IN 2020	14209.429	3.8%
COVID-19 MEASURES IN 2021	**Write-offs of direct taxes and contributions**	1448.213	0.4%
	pension and healthcare insurance contribution		
	COVID related subsidies to sectors of agriculture	150	0.0%
	Subsidies to preserve employment	3678.057 221.943	1.0%
	Reimbursement of fixed costs	275.8	7.0%
	Remuneration due to temporary incapacity for work	150	0.0%
	Supplement to pensions due to COVID-19 pandamic	600	0.2%
	Social transfers in kind in health sector	500	0.1%
	Active labor market policies (training)	1200	0.3%
	Acquisition of vaccine, medical and protective equipment to combat COVID-19	1823.527	0.5%
	TOTAL FISCAL EFFECTS OF COVID-19 MEASURES IN 2021	10047.54	2.5%

Sources: Croatian authorities and IMF staff calculations.

20. Staff stressed that economic recovery should be the central priority. Given the possibility that the pandemic may not fade out as quickly as expected, the authorities should focus on spending available resources to protect the health of the population, and the economy. Indeed, the job retention and wage subsidy schemes may exceed the authorities' current projections.[11] If economic conditions prove weaker than the baseline, newer tax deferrals—more limited in size relative to 2020—can be considered. The guarantees provided to corporations do not seem to pose

[10] In April 2021, The European Investment Fund (EIF) provided guarantees worth €140 million to Erste Group in Croatia, allowing the Croatian lender to originate a portfolio of €200 million of financing for Croatian SMEs. In May 2021, EIF guarantees to HBOR unlock up to €50 million in loans to support faster recovery of Croatian SMEs and small mid-caps. Moreover, EIF guarantees allow UniCredit to offer up to €300 million in more accessible financing for Covid-19 recovery to SMEs in Croatia, Bulgaria, and Slovakia. In June 2021, EIB and HBOR have signed a Guarantee Agreement amounting to €50 million for loans to Croatian mid-caps and large corporates to finance their recovery from the effects of the Covid-19 pandemic.

[11] Staff's fiscal projections only include the consolidation measures that are already in place.

major fiscal risks to the government's balance sheet.[12] The existing job support schemes could be progressively replaced with more resources to vocational training in areas like greening and construction if conditions permit. Contingency plans were discussed, in case the pandemic lasts well into 2022. In the event that the epidemiological conditions worsen significantly, further fiscal support would be needed. Based on the cost of measures in 2020, and the extent to which the situation worsens in such a scenario, this extra support could reach 1.0–1.5 percent of GDP for 2021 and should not be met by squeezing other aspects of social spending. Staff recommended that even in a situation where the recovery continues apace, "windfalls" relative to staff's assumptions could be put towards reskilling and ALMPs.

Authorities' Views

21. The authorities see the growth momentum as strong enough to balance the current pace of withdrawal of support. Job support measures will be in place until the tourism sector recovers, with possible changes in eligibility criteria going forward (given the sharp decline in the number of applicants). If the epidemiological situation worsens, the support will continue to come from spending (reallocation by more than 5 percent from other spending). While the immediate priority is to maintain fiscal support for viable companies, the authorities agreed that the focus should gradually shift from supporting jobs to supporting workers and sectoral reallocation via active labor market measures. As part of the NRRP reforms, the government will, by 2022:Q1, aim to supplement active labor market policies so as to adjust skills according to market needs.

Taxes

22. Staff also emphasized the need to conserve revenues and advised against further tax cuts. Three rounds of tax changes were implemented in 2017–19. Reforms included modifications to all major tax categories, with a negative overall impact on the government budget estimated at HRK 6.6 billion, or 1.6 percent of 2019 GDP. Several reductions in the VAT system were designed to support lower-income households.[13] The number of PIT rates was reduced from three to two (with a reduction in the top statutory rate), the personal allowance was increased significantly, and non-taxable allowances were broadened. Labor taxes were, however, mainly reduced for higher income earners, given that lower income households in most cases already paid no personal income tax.[14] The statutory CIT rate was reduced from 20 percent to 18 percent and a reduced rate of 12 percent was introduced for SMEs (with revenues up to HRK 3mn). These cuts were partially offset by the termination of a tax break on the amount of reinvested profits. The tax cuts introduced in 2021 entail further permanent revenue losses (amounting to 0.5 percent of GDP, Text Tables 1–2, Box 1). Staff

[12] The EC has approved subsidized loans and guarantees to vulnerable sectors, channeled through the Croatian Development Bank and the Agency for SMEs.

[13] While the standard VAT rate remained unchanged, the government broadened the list of goods and services to which the reduced VAT rate was applied. The cuts covered inputs applied in agriculture to support small farmers, electricity and utility services, and several foodstuffs. On the other hand, in 2017 a standard VAT rate was imposed on food and drink services in restaurants, which was reversed in 2020.

[14] Other changes in the PIT included a more progressive scale for expanding the personal allowance for dependent children, while the eligibility criteria for other supported family members was narrowed.

underscored that an emerging tax gap will endanger the structural fiscal position, and the ability to cope with future shocks–idiosyncratic, or otherwise.

Authorities' Views

23. The authorities view tax reforms beginning in 2017 as reducing fiscal and administrative burdens. The increase in tax rates and broadening of the tax base during 2009–2016 were driven by the need for fiscal adjustment in the aftermath of the GFC and alignment with EU legislation. Changes included higher consumption taxes and PIT cuts for low-income earners and increases in social benefits. Adjustments to the VAT and income taxes started before the pandemic (2017–19) and the recent changes (Box 1) are part of the reform package. The authorities expect tax cuts to boost private investment, the incentives to work, and ultimately economic growth, thus alleviating the negative impact on revenues. In addition to tax relief measures in 2020–21 (Box 1), the authorities pointed to the administrative relief the reforms facilitate (e.g. reducing requirements to submit documentation in person, tax administration measures that make invoicing more transparent and quicker to process). Further tax changes may be considered, e.g. reduced VAT rates on all food items, contingent on the strength of the recovery.

Medium-Term

24. For the medium-term, deficits and debt should be put on downward trajectories.[15] In the past, the rigid budget was unable to accommodate a significant reallocation of resources toward investment (Text Table 3) within a target of broad structural balance. Now, Croatia has a unique opportunity to tackle this challenge with the influx of EU funds. The national fiscal rule should be revived upon recovery, together with the accompanying institutional changes needed to ensure achieving the MTO.[16] With greater determination in wage bill restraint, and tangible efforts to better target social benefits (2017 Article IV Staff report), it could be more feasible to lower expenditures in these crucial areas to the levels the authorities are currently targeting in 2024, by the end of the forecast horizon.

25. Improved Public Investment Management (PIMA) capacity would help increase EU funds absorption, and public investment. The framework for the evaluation and spending of public programs needs to be strengthened. A PIMA mission is envisaged by year-end; it will also examine the SOE sector, recommending separate capacity development if needed. At end-2020, less than 50 percent of allocated funds had been spent—one of the lowest utilization rates in the EU. Staff's baseline forecast has an implicit short-term fiscal multiplier of 0.5. If the forthcoming EU funds were invested promptly and efficiently with the appropriate emphasis on digitalization and greening, the multiplier could be higher, thereby mitigating the scarring effects of the pandemic and safely reducing public debt further (Annex VII).

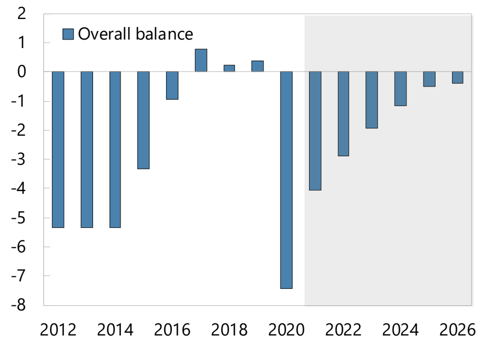
[15] Croatia's MTO is currently set at -1.0 percent of GDP, but once the country enters the eurozone it will be lowered to -0.5 percent, in line with the fiscal provisions of TSCG.

[16] In 2018, Croatia adopted the new Fiscal Responsibility Act (FRA), which increased national ownership of EU fiscal rules and strengthened the independence of the national Fiscal Policy Commission. The new FRA prescribes numerical fiscal rules in line with the main SGP provisions, including the obligation to achieve a structural balance target in line with Croatia's MTO, and expenditure and public debt rule.

Figure 9. Fiscal Developments and Projections

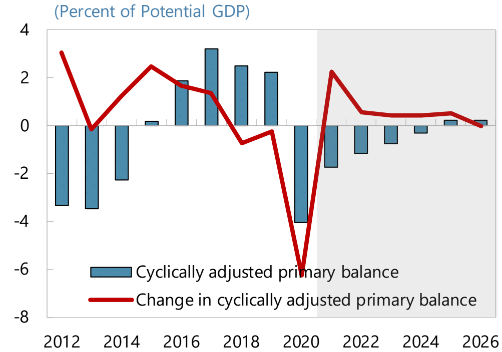
The fiscal deficit surpassed 7 percent of GDP in 2020 due to the severe economic contraction and Covid-19 support but recovery/consolidation is underway.

Overall General Government Balance
(Percent of GDP)



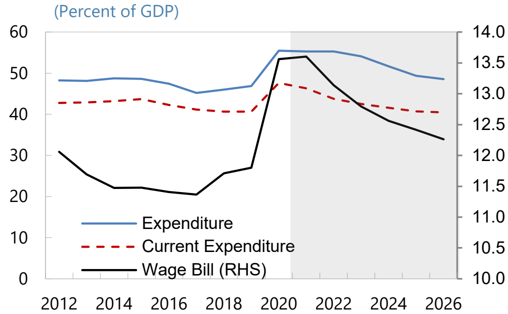
..the structural balance entered negative territory after five years of surplus and is expected to recover as recovery/consolidation takes hold.

Cyclically-Adjusted Primary Balance
(Percent of Potential GDP)



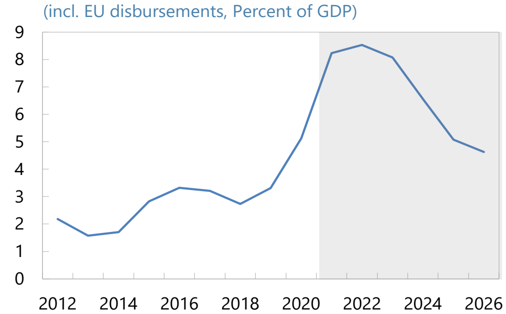
..expenditure surged, led mainly by higher social spending, including labor support measures.

Expenditure
(Percent of GDP)



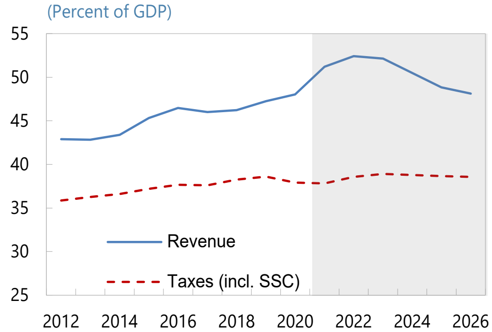
..absorption of EU funds has continued to improve in 2020, facilitated by the new EU funds for recovery and resilience.

Grants
(incl. EU disbursements, Percent of GDP)



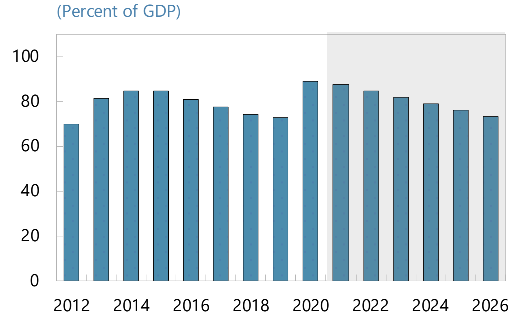
Despite an increase in revenue-to-GDP, tax revenues have declined faster than GDP, due to tax cuts/ exemption measures.

Revenue
(Percent of GDP)



..large fiscal deficits during the crisis raised the already elevated (albeit declining prior to pandemic) governement debt in 2020.

Public Debt
(Percent of GDP)



Sources: Croatian Authorities; Haver Analytics; and IMF staff calculations.
Note: The structural balance is based on a simplified aproach to the cyclically-adjusted balance, in percent of potential GDP, excluding one-off factors

Authorities' Views

26. The authorities expect that higher growth in the next five years will help reduce the public debt. They agree that sustained higher economic growth will depend on efficiently investing the generous allocation of grants from the EU and meeting the complementary reform conditionality. The authorities are confident that the devastation suffered due to the pandemic and the earthquakes, and the tangible benefits that the funds could provide will help them overcome past inertia. Reforms are also planned by end-2021, to ensure the full functionality of the Fiscal Policy Commission and strengthening the fiscal framework through the adoption of the Budget Act to improve the budgetary processes. The authorities welcomed the forthcoming PIMA mission. They agreed that strengthening administrative capacity for the use of EU funds will be essential. The Act on the institutional framework for EU funds (envisaged 2021:Q4), aims to strengthen the capacity of beneficiaries to prepare, apply and implement projects.

Text Table 3. Croatia's Spending Flexibility

(Rigid[1] spending in percent of general government revenue net of grants)

Public Expenditure	2017	2018	2019	2020	2021	2022	2023	2024	2025
Social benefits	36	36	35	41	39	37	36	35	36
Compensation of em	27	27	27	32	32	30	29	29	28
Interest payments	6	5	5	5	4	4	3	2	2
Subsidies	4	4	4	9	7	4	4	4	4
Total	73	71	71	86	83	76	72	71	70

Source: Croatian authorities; IMF staff estimates

1/ Rigid spending includes: wages, social contributions, subsidies, interest payments, and intermediate consumption. Flexible spending includes fixed capital expenditure and other current transfers.

C. Structural Fiscal Reforms: Can Croatia Regenerate a more Dynamic State?

27. Staff stressed that reforms are essential, *inter alia*, in the following areas:

- ***Administrative Reforms:*** Public employment outlays as a share of GDP is high, relative to much of the EU—both due to levels of employment and wages. Differences in classifications of public employees may account for some of this, yet there is a need to streamline the civil service, as well as the number of local government units (whilst merging their services in low population counties). A simplified and transparent public sector remuneration system that rewards merit and productivity[17] could bring substantial benefits, although such reforms could prove challenging.

- ***Healthcare:*** Health sector arrears, at nearly 2 percent of GDP, constitute a growing fiscal risk. The reliance on stop-gap measures to take care of arrears need to be replaced by a deeper overhaul. Structurally, staff encouraged authorities to increase efficiency through better use of economies

[17] A comprehensive review of the appropriate compensation for job positions in the system should be undertaken to eliminate the lack of transparency now inherent in the maze of complexity coefficients and supplements. This could be used to design a single, unified wage/salary system for civil servants and employees, public servants and employees, and state and judiciary officials.

of scale in drug procurement and merging service provision in under populated areas—particularly as implementing increases in healthcare contributions seems relatively more challenging.

- ***Pensions*****:** Pillar 1 pensions are inadequate, following the abolishment of 2018 pension reforms, which may additionally pressure on public finances in the medium-term.[18]

Authorities' Views

28. A significant share of these reforms are slated to be delivered between now and 2024. These include: (i) Steps to encourage the voluntary functional or actual merger of the local government units (LGUs) by 2022:Q1; (ii) Healthcare: functional integration of hospitals and joint procurement procedure for health institutions by 2023:Q4; and (iii) amendment of the Health Care Act and Compulsory Health Insurance Act (2022:Q4). However, the finalization of some politically sensitive reforms in these areas are scheduled to take place during 2025–26. While the authorities agreed that further adjustments are needed to make Pillar one pensions adequate, they noted that the three-pillar pension system will, however, partially mitigate pressures of an aging population.

D. Exchange Rate, Monetary, and Financial Policies: Accommodating with Vigilance on Risks

Exchange Rate and Monetary Policy

29. The authorities hope to adopt the euro in January 2023. Since 1993, Croatia has operated a de facto peg—initially to the Deutsche mark and later to the euro. The anchor was further entrenched with the ERM II membership in July 2020. Staff has continuously argued that the best way to fully reap the benefits of the exchange rate anchor, and ultimately euro adoption, is to make the economy flexible and dynamic with a view to facilitate smooth real sector adjustments, specifically to mitigate asymmetric shocks and to boost productivity and sustainable living standards.

30. The convergence criteria for euro adoption are likely to be assessed by mid-2022.[19] If observed, Croatia could adopt the euro as soon as early 2023. Croatia is not subject to the Excessive Deficit Procedure (EDP) given its track record and the fact that both the public deficit and debt are projected to decline. Consistent with the broader message of prioritizing economic recovery, staff urged the authorities to avoid excessive tightening in pursuit of euro adoption if new adverse shocks emerge. The authorities have also made the following commitments for euro adoption: Strengthening the AML framework (following the transposition of the 5th directive); Reducing administrative burdens for business; Improving SOE governance (revising and aligning regulation

[18] In October 2019, pension reforms (passed in 2018) which raised statutory retirement ages and penalties for early retirement were reversed, bowing to strong political pressures. This is not expected to have a notable impact in the short-term but could encourage more early retirements in an already aging population.

[19] In addition to compatibility of national legislation, the quantitative criteria for euro adoption comprise: price stability; sound and sustainable public finances (public balance and debt of the general government); convergence durability (limited deviation of long-term interest rates); and exchange rate stability (participation in ERM II for a minimum of two years without exchange rate pressures). The recent assessments were done by the EC and ECB in June 2020.

and practices in accordance with the OECD guidelines and recommendations); Improving the national insolvency framework (enhance the qualification requirements for liquidators and adopt a framework for a comprehensive insolvency database). Moreover, early warnings are expected to be introduced with the transposition of the 2019 EU Directive on Preventive Restructuring Frameworks.

31. The highly expansionary monetary policy, within the exchange rate anchor and ample global liquidity, is appropriate. The output gap is still large, and there are no large or persistent imbalances. However, as the recovery gains traction, continued vigilance on risks is warranted. If rapid domestic credit growth fuels imbalances and persistently higher inflation than in the euro area, the CNB may need to reduce excess liquidity in the banking system, while maintaining exchange rate stability. Conversely, should significant negative shocks reemerge, causing dysfunctionality in financial markets, tailored temporary measures, like those used during the pandemic, may be needed. Should potential imbalances prove persistent, the overall policy mix, including structural reforms, may need to be adjusted to facilitate real sector adjustment.

Banking System

32. Continued supervisory vigilance is warranted. The reported credit quality is expected to deteriorate, with the expiration of the moratoria and the accompanying flexible loan classification, as indicated by the recent increase of stage II loans (particularly to NFCs). Provisions, however, remain high. New tax rules, effective in 2021, will facilitate bank write-offs of NPLs. While a commendable step, the effectiveness remains to be seen, as some banks may prefer the proven practice of NPL sales. The CNB's stress testing exercise (based on end-2020 data), shows that banks have sizable loss-absorption capacity. In a severe adverse scenario with negative real GDP growth during the 2021–23 period, the conservative SREP capital requirements were encroached by eleven banks, accounting for about 4.8 percent of total assets, while eight banks encroached the pillar I capital requirement (8 percent).[20]

33. Housing loans remained strong during the pandemic. In 2020, about 10 percent of the households negotiated a debt-service moratorium. Most had expired by March 2021. Uncollateralized general-purpose cash loans declined. The increasing NPL ratio for these loans may be an opportunity to revisit some of the credit scoring models. Conversely, housing loans have continued to grow, underpinned by low interest rates, favorable taxation,[21] and the support scheme for first time buyers.[22]

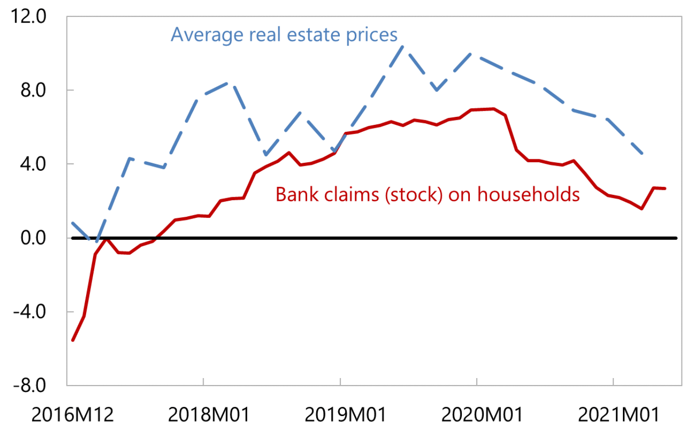
[20] This extreme scenario assumes negative real GDP growth during 2021–23 (respectively, -1.2; -4.0; and -1.4 percent), a depreciation of the currency (almost 7 percent), and a decline in real estate prices (see chapter seven in the CNB's May 2021 Financial Stability Report).

[21] There is a real estate transaction tax. However, a well-calibrated modern property tax could be less distortive if it would better account for the quality of the residence and whether is intended as an investment property for rentals. Also, for broader reasons of diversifying revenues, as well as reducing distorting incentives favoring real estate, a modern real estate tax would be desirable, but it is not seen as politically feasible.

[22] The current housing support scheme for young families were introduced in 2017 and since adjusted. In 2020, it was doubled and there were two rounds in contrast to only one in previous years. It may have reduced the rationing element that previously tended to boost prices during the months it was available. In 2021, there will only be one round, but the period is extended. Data suggest that the average loan-to-collateral-value (LTC) and debt-service-to-income (DSTI) were slightly higher for subsidized housing loans.

34. The growth of real estate prices decelerated, and the number of transactions declined during the pandemic. The Airbnb markets in the capital area and on the coast proved relatively resilient. The CNB estimates that the composite real-estate price index is now slightly above what is warranted by fundamentals. The two earthquakes and increasing prices on construction materials have added to the cost pressures. Although some transactions are credit financed, others are driven by foreigners (mainly on the coast) and wealthy Croatians with higher savings. Still, if housing prices accelerate further beyond fundamentals, macroprudential measures should be considered. The current implicit debt-service-to-income (DSTI) ratio only refers of housing loans and cash loans with maturities of five years and longer.[23] A formal DSTI should ideally cover all debt-service, including leasing. The strengthened macroprudential authority granted to the CNB and its new granular database should help both monitoring and calibration of possible borrower-based macro-prudential measures in the event of a credit-driven housing boom.

Real Estate Prices and Bank Claims on Households, 2016 - 2021
(Annual percentage change)



Sources: Croatian National Bank (CNB); and IMF staff estimates.

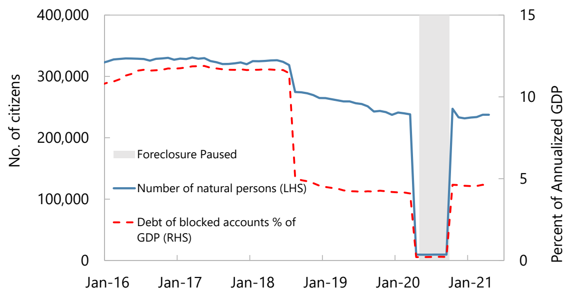
Authorities' Views

35. The authorities see euro adoption as a primary strategic priority. They are hopeful of observing the criteria by mid-2022 and will be ready to implement the euro beginning of 2023. They see the highly expansionary monetary stance as having usefully supported bank lending during a period of heightened uncertainty. Should rapid domestic credit growth fuel imbalances, the CNB agreed that reducing excess liquidity will be considered, while maintaining exchange rate stability. The CNB will continue to closely monitor credit developments, including drivers of real estate prices.

[23] The Foreclosure Act was amended effective mid-2017, to stipulate the amount that a creditor cannot seize. For below average net salary (published by the Croatian Bureau of Statistics) debtors, this is ¾ of their net salary. For other debtors, the salary exempt from seizure is ⅔ of the average net salary. The CNB began to require banks to apply the same *indirect* debt-service-to-income-ratio but only for housing loans. The CNB has since recommended that it also apply to general-purpose cash loans with a maturity of five years or longer.

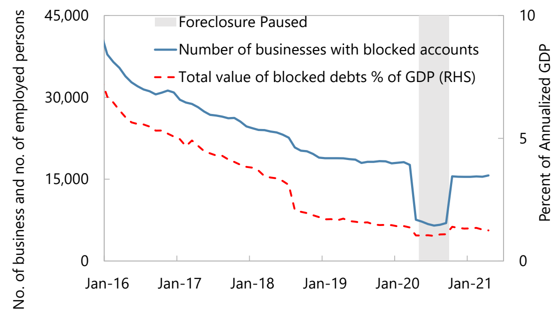
Figure 10. Bank Lending and NPLs, 2016–2021

Natural Persons with Blocked Accounts, 2016 - 2021
(Number of citizens with blocked accounts and amount of debt owed)



Sources: FINA and IMF staff calculations.
Note: Debt of blacked account in percent of annualized GDP.

Businesses with Blocked Accounts, 2016 - 2021
(Number of businesses and debt owed)

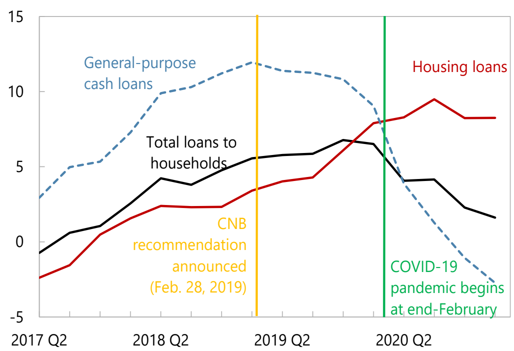


Source: FINA and IMF staff calculations.
Note: Value of blocked debt in percent of annualized GDP.

Lending for housing has picked-up, while general-purpose cash loans have declined.

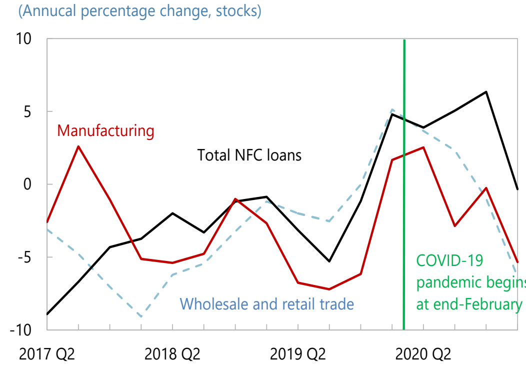
Bank lending to NFCs remained firm after the Covid-19 shock.

Growth Rates of Different Loans to Households, 2017 - 2021
(Annual percentage change, stocks)



Sources: Croatian National Bank (CNB); and IMF staff calculations.

Growth Rates of Different Loans to NFCs, 2017 - 2021
(Annucal percentage change, stocks)

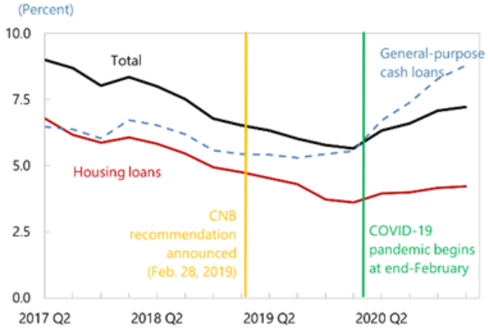


Sources: Croatian National Bank (CNB); and IMF staff calculations.
Note: Loans to manufacturing and trade account for respectively 20 and 19 % of total NFC loans.

NPLs of general-purpose cash loans has picked-up.

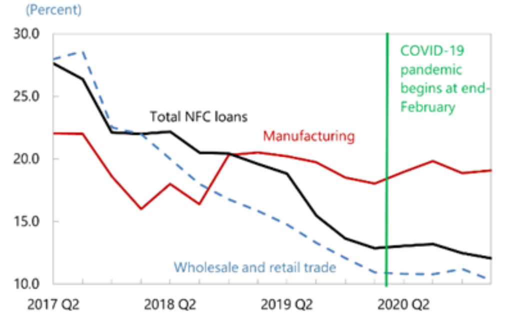
Average NPLs of NFC lending has remained stable.

NPL Ratios of Different Loans to Households, 2017 - 2021
(Percent)



Sources: Croatian National Bank (CNB); and IMF staff calculations.

NPL Ratios of Different Loans to NFCs, 2017 - 2021
(Percent)



Sources: Croatian National Bank (CNB); and IMF staff calculations.
Note: Loans to manufacturing and trade account for respectively 20 and 19 % of total NFC loans.

STAFF APPRAISAL

36. The economy is showing resilience. Croatia has managed the pandemic shock relatively well. Due to swift implementation of measures, the economy has avoided much worse outcomes some other economies with similar levels of tourism-dependence have experienced. The economy appears set for a recovery driven by a rebound in tourism sector and investment—assuming the pandemic does not provide further unwelcome surprises.

37. The immediate priority is to support the nascent recovery. Support measures are being modified and targeted to lagging sectors. They should remain in place to ensure a full economic recovery. As conditions improve, support measures need to rotate toward facilitating digitalization, and transitioning to a greener economy. If downside risks materialize, support measures should be broadened once again.

38. Croatia must fully seize the opportunity that the influx of EU funds represents. Utilizing these funds efficiently would allow the country to raise public investments in an environmentally sustainable way that lifts growth and the quality of life for its citizens. It would also facilitate a significant reduction in debt, whilst significantly narrowing the current per capita income gap with the EU average. Over the medium-term, it will be important to conserve fiscal resources and avoid further tax cuts to help decisively place elevated public debt levels on a firmly downward trajectory.

39. This opportunity requires significant complementary reforms. The government's ability to deliver its ambitious medium-term fiscal plan and the needed reforms over the next three years will be decisive. Strengthening absorption capacity and public investment management practices will be key to translating current plans into successful outcomes. This could initiate a virtuous cycle wherein net emigration is decisively reversed, with the attendant salubrious effects on the sustainability of healthcare and pensions systems.

40. There is no immediate need to adjust the monetary stance, but the authorities need to remain vigilant. If any imbalances manifest through credit demand or credit driven housing price rises, the CNB should stand ready to reduce excess liquidity in the banking system, and/or introduce more explicit macroprudential measures to alleviate them. Should imbalances still prove persistent, the overall policy mix may need to be adjusted to facilitate real sector adjustment, while maintaining exchange rate stability. NPLs are likely to increase with the expiration of the moratoria, hence continued supervisory vigilance is warranted.

41. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Box 1. Recent Changes Affecting Tax Revenues

2020

CIT

- The 12% rate threshold raised to HRK 7.5 million (93% of taxpayers).

PIT

- Basic personal allowance increased from HRK 3,800 to HRK 4,000.
- Reduced tax liability for the young by 100% (□25 years) and by 50% (26-30 years) for annual salary below HRK 360K.
- Dependent deduction for student dual education remuneration and awards (up to HRK 15K).
- Wider coverage exemptions (donations, supplementary health insurance premia).
- Tax and surtax from renters' taxation paid according to property location.

VAT

- The 13% rate coverage expanded to phonogram rights holders and food preparation and serving
- Threshold of taxation based on collected fees increased to HRK 7.5M.
- Generalized VAT exemption for supplies into activities of public interest (health, education).
- Harmonization with EU Directive 2018/1910 on harmonizing and simplifying the VAT for the taxation of trade between Member States.

2021

CIT

- Rate reduced from 12% to 10% for taxpayers earning up to HRK 7.5M.
- Withholding tax rate on dividends and profit shares reduced from 12% to 10%; and from 15% to 10% on remunerations paid for performances by foreign performers.
- Compulsory transfer price adjustment prior to submitting the tax return.

PIT

- Rates reduced from 24% to 20%, from 36% to 30%, and from 12% to 10%, applied for tax levied on annual and final income and flat-rate taxation of activities.
- Exemption of national benefits for the elderly.
- Tax increased for income gained from "disproportion of assets".
- Property income (rent/lease) reported upon document delivery from notaries.
- Standardization of all taxpayers' annual accounts. Expansion of exemptions for self-employment; clarification of the digital nomad status.

VAT

- Harmonization with EU Directives 2017/2455 and 2019/1995 resulting in the abolition of VAT exemption for small consignments (below €22) imported into the EU.
- Higher threshold for taxation based on collected remunerations from HRK 7.5M to HRK 15M, to facilitate business operations.
- Reduce importers' tax burden by widening the application of accounting category of VAT on imports.

Box 2. The Significance of Next Gen EU Funds

The Next Gen EU funds carry a significant grant component. Croatia is, by far, the largest recipient of grants through the Next Gen EU funds, totaling some 11 percent of GDP over the next six years. The benefits of utilizing these funds for the country are extensive—rebuild from the earthquakes, upgrade physical and digital infrastructure, and help decarbonize the economy, to name just a few. Each of these benefits delivers improvements to the quality of life that cannot be captured entirely by narrow economic measures. This caveat acknowledged, staff has developed an indicative alternative scenario to illustrate its potential public and private economic benefits, if invested efficiently, and accompanied by the promised reforms.

What if these funds did not exist? Staff's baseline includes, *inter alia*, the following elements: (1) All Next Gen EU finds are absorbed by 2026; (2) The increase in public investment also crowds in private investment; (3) In tandem with the absorption of these funds, there is also a modest improvement in absorption of other structural EU funds; and (4) The implicit fiscal multiplier is 0.5, which might be regarded as conservative for public investment in an economy recovering from a deep shock. By contrast, the indicative alternative scenario assumes that there are no Next Gen EU funds, public investment is commensurately lower, there is no resulting extra crowding in of private investment, and structural EU funds absorption remains at its most recent level. The basic results are shown in the table below. In the alternative scenario, growth is lower, and fiscal deficits as a share of GDP are consistently higher. By the end of the forecast horizon in 2026, public debt is some 10 percentage points of GDP lower in the baseline. Per capita income (in 2020 euros) would be 690 euros higher in 2026. Furthermore, assuming that the economy then grows by 2.3 percent (anchored by pre-pandemic estimates of potential growth) in the alternative scenario till the end of this decade, compared with 3 percent in the baseline scenario, real per capita GDP at the end of this decade would be at some 17,200 euros, or 8 percent higher in the baseline scenario, representing an "extra" catch-up of 0.8 percentage points per year, with respect to the projected EU average. In sum, these economic benefits—funded by grants—are indeed significant, and represent a unique opportunity for the country, both qualitatively, and quantitatively.

in percent	2021	2022	2023	2024	2025	2026
			Baseline			
Growth	5.4	5.8	4.0	3.3	3.2	3.1
Public debt/GDP	87.6	84.4	81.6	78.9	76.1	73.3
Fiscal balance/GDP	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
GDP per capita (in 2020 Euros)	12,634	13,367	13,902	14,361	14,820	15,279
			Alternative Scenario			
Growth	4.8	4.2	3.2	2.7	2.6	2.5
Public debt/GDP	87.9	86.3	85.5	84.4	83.6	82.5
Fiscal balance/GDP	-4.2	-3.6	-3.5	-2.5	-2.1	-1.7
GDP per capita (in 2020 Euros)	12,562	13,090	13,509	13,874	14,234	14,590

Table 1. Croatia: Selected Economic Indicators, 2016–26

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
						Proj.					
Output, unemployment, and prices	(Percent change, annual average, unless otherwise indicated)										
Real GDP growth	3.5	3.4	2.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1
Contributions:											
Domestic demand	3.2	4.2	4.6	2.7	-2.3	3.9	6.5	4.9	3.1	1.7	1.7
Net exports	0.3	-0.7	-1.9	0.2	-5.8	1.5	-0.7	-0.9	0.2	1.5	1.4
Unemployment	15.0	12.4	9.9	7.8	9.0	8.5	8.0	7.7	7.2	7.0	6.8
CPI inflation (avg.)	-1.1	1.1	1.5	0.8	0.1	1.8	1.9	2.0	2.0	2.0	2.0
Saving and investment (percent of GDP)											
Domestic investment	21.0	22.0	23.4	22.6	25.6	26.4	27.2	28.0	28.5	27.6	27.0
Domestic saving	23.2	25.5	25.3	25.7	25.3	25.8	25.9	26.8	27.7	27.2	26.8
Government	3.5	4.4	5.0	5.7	-1.1	1.4	2.6	3.5	4.3	4.9	5.1
Nongovernment	19.7	21.1	20.2	20.0	26.3	24.4	23.4	23.2	23.4	22.3	21.7
Government sector (ESA 2010 definition)											
General government revenue	46.5	46.0	46.2	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
General government expenditure	47.4	45.2	46.0	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
General government balance	-1.0	0.8	0.2	0.4	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Structural balance 1/	-1.0	0.8	1.5	0.5	-5.7	-3.2	-2.6	-1.8	-1.1	-0.5	-0.4
General government debt 2/	80.8	77.5	74.2	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
Balance of payments (percent of GDP)											
Current account balance	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Capital and financial account	-2.3	1.5	0.8	-1.0	2.4	7.0	4.3	3.6	2.0	0.9	0.5
FDI, net	4.3	2.3	1.6	6.3	1.6	1.9	1.8	1.8	1.8	1.8	1.8
Debt and reserves											
Gross official reserves (billions of euros)	13.5	15.7	17.4	18.6	18.9	22.3	24.0	25.4	26.1	26.4	26.6
IMF metric (percent) 3/	88.5	102.0	112.4	103.4	125.6	138.9	143.2	147.2	146.9	145.7	144.4
In months of imports in goods and services (based on next year level)	7.5	7.8	7.9	7.9	9.3	9.7	8.8	8.6	8.3	8.0	7.6
Total external debt (percent of GDP)	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
Money and credit	(End of period, change in percent)										
Broad money (M4)	4.7	2.1	5.5	2.9	9.3	7.0	5.0	4.5	4.0	4.0	4.0
Claims on other domestic sectors 4/	-3.4	-0.8	1.8	2.6	3.3	...	...	...	...	...	...
Interest rates											
Average 12-month T-bill interest rate (in kuna)	1.0	0.4	0.1	0.1	0.1	...	...	...	...	...	...
Kuna credit rate (unindexed, outstanding amount)	6.5	6.0	5.7	5.2	4.8	...	...	...	...	...	...
Exchange rate											
Kuna per euro	7.6	7.5	7.4	7.4	7.5	...	...	...	...	...	...
Real effective exchange rate (percent, "-" = appreciation)	0.3	0.7	1.9	-1.4	...	...	...	...	...	...	...
Memorandum items:											
Nominal GDP (billions of euros)	46.6	49.3	52.0	54.3	49.3	52.4	56.2	59.8	63.0	66.0	69.1

Sources: Croatian authorities; and IMF staff estimates. Unemployment rate is from Croatian Bureau of Statistics and Haver Analytics.

1/ Based on a simplified aproach to the cyclically-adjusted balance, in percent of potential GDP, excluding capital transfers to public enterprises and one-off investment retrenchment in 2015. The 2020 overall budget balance (-7.4 percent of GDP) minus the cyclical component (-1.7 percent of GDP) results in a cyclically adjusted budget balance of -5.7 percent of GDP. Includes the one-offs related to the COVID-19 package of -3.8 percent of GDP. For 2021, the overall budget balance (-4.1 percent of GDP) minus the cyclical component (-0.9 percent of GDP) results in a cyclically adjusted budget balance of -3.2 percent of GDP. Includes the one-offs related to the COVID-19 package of -2.5 percent of GDP.

2/ Gross debt as defined by the EU under the Maastricht Treaty.

3/ IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals" IMF Policy Paper, Washington: International Monetary Fund.

4/ Comprises claims on households and non-financial corporations.

Table 2. Croatia: Medium-Term Baseline Scenario, 2016–2026

(Percent of GDP, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Est.	proj.					
Real GDP (percent change)	3.5	3.4	2.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1
CPI inflation (average)	-1.1	1.1	1.5	0.8	0.1	1.8	1.9	2.0	2.0	2.0	2.0
CPI inflation (end-of-period)	0.2	1.2	0.8	1.4	-0.7	2.7	2.1	2.0	2.0	2.0	2.0
Real sector (percent change)											
Domestic demand	3.2	4.2	4.6	2.9	-2.5	3.6	6.1	4.6	2.9	1.6	1.6
Consumption, total	2.5	2.9	3.1	3.5	-3.8	3.7	5.0	3.7	2.7	2.3	2.0
Gross fixed capital formation, total	6.5	5.1	6.5	7.1	-2.9	7.7	16.4	8.4	0.5	0.2	0.2
Saving and investment											
Domestic investment	21.0	22.0	23.4	22.6	25.6	26.4	27.2	28.0	28.5	27.6	27.0
Domestic saving	23.2	25.5	25.3	25.7	25.3	25.8	25.9	26.8	27.7	27.2	26.8
Balance of payments											
Current account balance	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Exports of goods, f.o.b.	22.5	23.8	23.5	23.7	24.7	24.2	23.9	23.8	24.4	24.4	24.2
Imports of goods, f.o.b.	38.8	40.9	42.1	43.0	42.2	44.8	49.3	50.1	50.3	50.8	50.8
Capital and financial account	-2.3	1.5	0.8	-1.0	2.4	7.0	4.3	3.6	2.0	0.9	0.5
Of which : FDI, net	4.3	2.3	1.6	6.3	1.6	1.9	1.8	1.8	1.8	1.8	1.8
Gross official reserves	29.0	31.9	33.5	34.2	38.4	42.5	42.6	42.5	41.5	40.1	38.5
Gross external debt	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
General government finances											
Revenue	46.5	46.1	46.3	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
Expenditure	47.5	45.3	46.1	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
Balance	-0.9	0.8	0.2	0.3	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Government debt	80.8	77.6	74.3	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
Memorandum items:											
Nominal GDP (billions of kuna)	351.2	367.5	385.4	402.3	371.5	394.4	423.5	450.1	474.5	496.8	520.7
Output gap	0.0	0.0	-0.5	0.4	-3.8	-2.0	-0.8	-0.3	-0.2	-0.1	0.0
Potential GDP growth	2.4	3.2	3.2	2.3	-4.0	3.5	4.5	3.5	3.2	3.0	3.0

Sources: Central Bureau of Statistics; Croatian National Bank; Ministry of Finance; and IMF staff estimates.

Table 3. Croatia: Statement of Operations of General Government, 2016–2026

(Percent of GDP, ESA 2010)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
								Proj.			
Revenue	46.5	46.1	46.3	47.5	48.0	51.2	52.4	52.1	50.5	48.8	48.1
Taxes	25.8	25.7	26.3	26.8	25.8	26.0	26.3	26.2	26.0	25.9	25.8
Income tax	5.9	5.7	5.9	5.9	5.6	5.4	5.4	5.3	5.1	5.0	4.9
VAT	12.9	13.1	13.4	13.7	12.8	13.2	13.4	13.4	13.4	13.4	13.4
Excise	4.4	4.5	4.6	4.5	4.6	4.7	4.7	4.7	4.7	4.7	4.7
Import duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.6	2.4	2.5	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Social contributions	11.9	11.9	11.9	11.8	12.1	11.8	12.3	12.8	12.8	12.8	12.8
Other revenue	4.4	4.2	3.6	4.2	6.0	9.2	9.7	9.1	7.5	6.0	5.4
Grants 1/	3.3	3.2	2.7	3.3	5.1	8.4	8.8	8.2	6.7	5.2	4.6
Property income	1.0	1.0	0.8	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8
of which interest receivable:	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Sales of goods and services	4.5	4.2	4.4	4.5	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Expenditure	47.5	45.3	46.1	47.2	55.4	55.3	55.3	54.1	51.7	49.4	48.5
Expense	44.1	42.5	42.4	42.5	49.7	48.2	45.7	44.4	43.5	42.6	42.4
Compensation of employees	11.4	11.4	11.7	11.9	13.6	13.6	13.1	12.8	12.6	12.4	12.3
Use of goods and services	8.2	8.0	8.1	8.4	8.7	8.8	8.6	8.5	8.5	8.5	8.5
Interest, payable	3.1	2.6	2.3	2.2	2.0	1.7	1.6	1.3	1.0	0.9	0.9
Subsidies	1.3	1.5	1.6	1.5	3.8	3.2	1.9	1.9	1.9	1.9	1.9
Current grants 2/	2.3	2.1	1.5	1.3	2.1	2.2	2.2	2.2	2.1	1.4	1.4
Social benefits	16.0	15.6	15.4	15.5	17.4	16.8	16.3	15.9	15.5	15.5	15.5
Other expenses	1.8	1.3	1.8	1.9	2.0	1.9	1.9	1.9	1.9	1.9	1.9
Net acquisition of nonfinancial assets	3.4	2.8	3.6	4.4	5.8	7.1	9.6	9.7	8.1	6.8	6.2
Overall Balance	-0.9	0.8	0.2	0.3	-7.4	-4.1	-2.9	-1.9	-1.2	-0.5	-0.4
Memorandum item:											
General government gross debt 3/	80.8	77.6	74.3	72.8	88.7	87.6	84.4	81.6	78.9	76.1	73.3
General government net debt 4/	68.7	65.6	62.4	…	…	…	…	…	…	…	…
Structural balance 5/	-1.0	0.8	1.5	0.5	-5.7	-3.2	-2.6	-1.8	-1.1	-0.5	-0.4

Sources: Eurostat; and IMF staff estimates.

1/ Mostly EU structural and investment funds.

2/ Non-capital transfers financed by the EU structrual funds and national co-financing.

3/ Gross debt as defined by the EU under the Maastricht Treaty.

4/ Net debt is calculated as gross debt minus deposits, loans and debt securities as reported by Eurostat.

5/ Based on a simplified aproach to the cyclically-adjusted balance, in percent of potential GDP, excluding capital transfers to public enterprises, one-off investment retrenchment in 2015, payment of guarantees of Uljanik shipyards in 2018/19; and Covid-19 fiscal package in 2020.

6/Components of expenditures and revenues may not add to the total due to rounding.

Table 4. Croatia: Monetary Accounts, 2016–2021:Q1

(End of period, billion of Kuna, unless otherwise indicated)

	2016	2017	2018	2019	2020				2021
					Q1	Q2	Q3	Q4	Q1
Monetary survey									
Net foreign assets	104.7	121.8	129.9	140.9	138.9	148.3	151.4	149.9	155.7
Croatian National Bank	95.1	110.6	119.1	133.4	124.1	128.9	126.4	141.8	148.7
Deposit money banks	9.6	11.2	10.8	7.5	14.9	19.4	25.0	8.2	7.0
Net domestic assets	196.2	185.4	194.1	192.4	206.1	203.0	207.3	214.5	213.2
Domestic credit 1/	221.5	218.9	223.2	229.5	237.8	234.7	234.4	238.5	241.2
Consolidated domestic credit	294.3	279.2	286.5	288.3	306.1	302.7	307.6	314.1	315.4
of which: Claims on central government, net	72.8	60.2	63.3	58.7	68.3	68.1	73.1	75.6	74.1
Claims on other domestic sectors	214.8	213.0	217.1	223.1	230.8	228.9	228.6	231.9	234.0
Broad money (M4)	300.9	307.2	324.0	333.3	345.0	351.2	358.6	364.5	368.9
Narrow money (M1)	83.5	99.4	120.0	137.2	140.1	150.3	153.6	160.5	165.9
Currency outside banks	22.5	25.6	28.1	31.0	32.0	34.0	34.2	34.1	34.6
Demand deposits	61.0	73.9	91.9	106.2	108.2	116.3	119.4	126.3	131.3
Quasi money	217.4	207.8	204.0	196.1	204.9	200.9	205.0	204.0	203.0
Kuna-denominated	47.7	43.7	41.8	33.2	32.8	31.0	31.5	32.1	32.0
Foreign currency-denominated	169.7	164.1	162.2	163.0	172.1	169.9	173.5	171.9	171.0
Balance sheet of the Croatian National Bank									
Net foreign assets	95.1	110.6	119.1	133.4	124.1	128.9	126.4	141.8	148.7
Net international reserves	95.0	110.6	119.1	133.3	123.5	125.9	125.9	138.8	142.4
Net domestic assets	-21.7	-24.1	-17.2	-24.7	-19.2	-18.6	-16.4	-16.3	-12.4
Claims on central government (net)	-3.5	-4.2	-3.7	-6.9	-2.0	-3.0	-0.8	0.8	1.5
Claims on banks	1.1	1.3	2.0	1.9	5.1	4.3	4.3	4.5	4.5
Claims on other domestic sectors	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items (net)	-19.3	-21.2	-15.4	-19.7	-22.3	-19.9	-19.8	-21.6	-18.4
Reserve money (CNB definition) 2/	73.3	86.4	101.8	108.4	104.5	110.0	109.7	125.1	136.0
Of which:									
Currency outside credit institutions	22.5	25.6	28.1	31.0	32.0	34.0	34.2	34.1	34.6
Kuna deposits of credit institutions	45.3	54.7	66.8	69.7	64.4	67.7	67.7	83.2	93.8
Of which:									
Settlement accounts	23.8	32.6	43.3	44.8	45.4	48.3	47.9	63.3	73.1
Statutory reserves in kuna	21.6	22.1	23.5	24.9	19.0	19.4	19.8	20.0	20.7
Year-on-year percent changes									
Monetary survey:									
Net domestic assets	1.1	-5.5	4.7	-0.9	7.5	8.3	16.0	11.5	3.4
Domestic credit 1/	-3.7	-1.2	2.0	2.8	5.0	3.5	4.1	3.9	1.4
Claims on central government, net	11.6	-17.2	5.0	-7.1	12.1	31.2	50.0	28.7	8.5
Claims on other domestic sectors	-3.5	-0.8	1.9	2.8	4.8	4.1	4.6	3.9	1.4
Broad money (M4)	4.7	2.1	5.5	2.9	8.8	8.7	6.5	9.3	6.9
Quasi money	0.3	-4.4	-1.8	-3.9	3.7	2.6	1.0	4.0	-0.9
Balance sheet of the Croatian National Bank:									
Reserve money (CNB definition) 2/	14.9	17.9	17.8	6.5	1.4	6.5	4.8	15.5	30.1
Memorandum items:									
Nominal GDP (yearly total) 3/	351.2	371.5	474.5	402.3	404.8	389.7	377.8	371.5	372.2
Broad money (percent of GDP)	85.7	82.7	68.3	82.8	85.2	90.1	94.9	98.1	99.1
Foreign currency (percent of broad money)	56.4	53.4	50.1	48.9	49.9	48.4	48.4	47.2	46.3
Claims on other domestic sectors: stock (% of GDP)	61.2	57.3	45.7	55.5	57.0	58.7	60.5	62.4	62.9
Claims on private sector (transactions, annual change,%) 4/ 5/	1.6	3.2	3.9	4.0	4.7	3.4	3.6	3.0	1.5

Sources: Croatian National Bank; and IMF staff estimates.

Note: As of January 2015, the Croatian National Bank started publishing monetary statistics in line with ESA 2010.

1/ Domestic credit comprises credit institutions' claims on other domestic sectors, other financial intermediaries, financial auxiliaries, as well as insurance companies and pension funds.

2/ Excludes statutory reserves in foreign currency.

3/ Quarterly annualized GDP is the sum of nominal GDP the last four quarters, not seasonally adjusted.

4/ Comprises claims on households and enterprises. Excludes other banking institutions (household savings banks, savings and loan cooperatives, and investment funds) and other financial institution:

5/ Transaction data exclude the effects of exchange rate changes, securities price adjustments and write-offs, including sale of placements in the amount of their value adjustments.

Table 5. Croatia: Financial Soundness Indicators, 2014–2021:Q1

(Percent, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020				2021
							Q1	Q2	Q3	Q4	Q1
Regulatory capital to risk-weighted assets	21.8	21.0	22.5	23.2	22.9	23.2	23.4	24.7	25.0	24.9	25.1
Regulatory Tier I capital to risk-weighted assets	20.6	19.2	20.9	21.8	21.8	22.4	22.7	24.0	24.3	24.3	24.6
Nonperforming loans net of loan-loss provisions to capital	41.1	34.2	19.4	14.2	12.9	5.6	4.9	4.9	4.4	5.4	5.4
Nonperforming loans to total gross loans 1/	16.7	16.3	13.6	11.2	9.7	7.0	6.7	6.8	7.0	7.2	7.1
Nonperforming loans to total gross loans 2/	...	...	*12.2*	*8.8*	*7.6*	*5.5*	*5.3*	*5.5*	*5.5*	*5.4*	*5.3*
Total loan-loss provision to nonperforming loans 1/	51.0	61.9	70.1	70.1	70.3	81.8	84.1	84.6	86.2	83.3	83.0
Return on assets	0.6	-1.2	1.6	1.1	1.4	1.6	1.2	0.9	0.9	0.7	1.1
Return on equity	4.6	-8.7	11.8	7.4	9.6	11.3	8.5	6.6	6.5	5.4	8.1
Interest margin to gross income	58.1	62.1	57.7	60.1	56.6	52.5	61.6	63.0	61.8	61.2	59.6
Noninterest expenses to gross income	57.3	61.9	53.4	56.5	54.3	51.8	59.6	58.4	58.8	59.2	55.8
Liquid assets to total assets 3/	27.3	27.7	29.6	33.0	34.4	34.4	33.6	33.3	34.1	36.2	36.7
Liquid assets to short-term liabilities 3/	42.7	41.9	42.6	47.3	47.1	46.7	45.5	44.6	45.6	48.1	48.5
Net open position in foreign exchange to capital	2.9	12.5	3.8	3.3	5.1	5.0	5.6	5.7	6.2	6.2	-4.3
Residential real estate prices, end of period (annual increase)	-1.4	-2.1	0.8	7.6	4.7	10.0	9.1	8.3	6.9	6.4	*4.6*

Source: Croatian National Bank and the IMF's *Financial Soundness Indicators (FSI)* .

Note: The classifications used in the table are consistent with the IMF's FSIs Database. However, figures in *italics* are most current figures provided by the CNB or the Croatian Bureau of Statistics.

1/ Total loan-loss provisions in percent of gross loans as defined by the FSIs.

2/ Total loan-loss provisions in percent of gross loans as defined by the ECB.

3/ Liquid assets are on a net basis. They include deposits at banks and at the central bank, short-term government and central bank paper and overnight loans extended; less required reserve funds, central bank loans received, and overnight loans received.

Table 6. Croatia: Balance of Payments, 2016–2026 1/

(Millions of euros, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Prel.			Proj.			
Current account	1,026	1,709	946	1,649	-179	-333	-702	-746	-504	-273	-151
Merchandise trade balance	-7,607	-8,450	-9,642	-10,451	-8,636	-10,802	-14,278	-15,754	-16,277	-17,411	-18,415
Exports f.o.b.	10,511	11,709	12,230	12,867	12,159	12,682	13,455	14,200	15,399	16,100	16,730
Imports f.o.b.	18,118	20,159	21,872	23,318	20,795	23,484	27,733	29,955	31,675	33,511	35,145
Services Trade Balance	8,178	8,800	9,224	10,338	5,308	7,451	11,076	12,657	13,652	14,848	15,992
Export of services	11,737	12,915	13,873	15,374	8,931	11,606	15,968	18,317	19,736	21,197	22,693
Imports of services	3,560	4,114	4,648	5,036	3,622	4,155	4,892	5,661	6,085	6,349	6,702
Primary income balance	-1,361	-698	-826	-702	361	-49	-337	-484	-718	-521	-566
Secondary income balance	1,817	2,057	2,190	2,464	2,788	3,067	2,837	2,835	2,839	2,812	2,839
Capital account	650	455	672	890	1,074	2,494	2,697	2,896	2,000	1,454	1,148
Financial account	-1,744	275	-240	-1,432	117	1,174	-303	-737	-768	-861	-807
Direct investment	1,998	1,119	844	3,412	809	1,021	1,026	1,091	1,150	1,204	1,262
Portfolio investment	-1,389	-397	-993	-1,319	75	-265	-388	-541	-545	-545	-544
Financial derivatives	149	371	-84	113	346	175	89	17	7	-7	-5
Other investment	-2,501	-820	-6	-3,639	-1,113	243	-1,031	-1,304	-1,379	-1,513	-1,520
Net errors and omissions	-198	154	167	-117	-409	0	0	0	0	0	0
Gross reserves (-= increase)	265	-2,592	-1,545	-989	-604	-3,335	-1,691	-1,414	-728	-320	-190
Memorandum items:											
Current account (percent of GDP)	2.2	3.5	1.8	3.0	-0.4	-0.6	-1.2	-1.2	-0.8	-0.4	-0.2
Export goods volume growth	5.2	9.0	3.2	4.6	-0.8	3.6	4.0	4.0	8.0	8.1	5.1
Import goods volume growth	6.1	7.4	6.7	6.3	-10.1	7.0	17.0	9.0	5.0	3.0	2.0
Gross official reserves	13,514	15,706	17,439	18,563	18,945	22,280	23,971	25,385	26,113	26,433	26,623
Percent of short-term debt	109.2	117.3	153.0	52.0	159.7	183.5	214.6	228.8	223.7	233.2	266.2
Months of next year's imports	7.5	7.8	7.9	7.9	9.3	9.7	8.8	8.6	8.3	8.0	7.6
External debt to GDP 2/	95.8	88.4	81.9	74.2	81.3	79.4	75.0	71.0	67.9	65.3	63.1
GDP (millions of euros)	46,638	49,257	51,981	54,269	49,320	52,364	56,227	59,754	62,993	65,956	69,129

Sources: Croatian National Bank; and IMF staff estimates.

1/ Partially based on BMP5.

2/ Since end-2008, external debt is reported based on the new reporting system (INOK).

Annex I. Implementation of IMF Recommendations

	2019 Article IV Advice	Actions Since 2019 Article IV
Improve the quality of the budget	Continue debt reduction, resist further pressures on the wage bill, and target structurally balanced budgets.	**Progress prior to pandemic.** The public debt continued to decline at 2.4 percentage points on average per year since 2015, albeit at a declining pace. The 2020 shock has reversed this downward trend.
	Evaluate long-term public investment priorities and rebalance spending to areas of relative deficiency.	**Progress in the context of NRRP.** The authorities have agreed to take CD on PIMA, envisaged to be completed by end-2021.
	Implement fiscal reforms to make the budget less rigid and more growth-friendly.	**Progress in the context of NRRP.** With Next Gen EU funds, public investment is envisaged to rise by EUR 6.23 billion over the next few years across areas (e.g. digitization, greening) broadly consistent with past Art-IV recommendations.
	Improve the efficiency of essential State-Owned Enterprises.	**Progress in the context of ERMII and NRRP.** Authorities have committed to some additional reforms under ERMII commitments and the NRRP (Annex VI)
Renovate the capital stock and create conditions for a broader economic base	Continue on-going improvements to the business environment.	**Some progress in reducing the administrative burden.** Emphasis has been placed on the administrative relief and administrative procedures.
	Increase EU funds absorption to close remaining gaps in physical and technological infrastructure.	**Some progress.** EU funds absorption has increased. However, by end 2020, less than 50 percent of allocated funds had been spent, which is one of the lowest utilization rates in the EU. EU funds absorption is expected to increase in the context of the NRRP, e.g., the adoption of the Act on the institutional framework for EU funds in 2021.
	Boost investment in human and technological capital.	**Some progress.** Investment in human and technological capital have increased somewhat.
Anchor stability through monetary and financial policies	Remain vigilant regarding growth of household borrowing.	**Done.** Growth of the risky uncollateralized cash loans has decelerated. Granular data are compiled.
	Facilitate corporate sector deleveraging.	**In progress.** Insolvency legislation to be enhanced before euro adoption.
	Make the credit registry fully operational again.	**Completed.** The credit registry has been fully reactivated since mid-2020.

Annex II. Public Debt Sustainability Analysis[1]

The public debt ratio has increased sharply in 2020 due to Covid-19 crisis, reversing the downward trend started in mid-2010s. *Under the baseline scenario, debt is expected to be around 87.6 percent of GDP at end-2021. It will continue to gradually decline over the medium term and reach 73.3 percent of GDP in 2026, slightly above its 2019 level. These projections remain sensitive to growth prospects and the materialization of contingent liabilities, such as the payment of healthcare arrears. On the other hand, there could be some gains if more state assets were divested (as planned in the NRRP), with the proceeds being used for public debt reduction.*

The pandemic has undone the gains that Croatia had previously made. From 2016–19, public debt came down by 8 percentage points, the budget moved from headline deficits to surplus, and the average growth rate was 3.1, compared with -0.4 for 2010–15. This trend of relative stability was abruptly interrupted in 2020, with the public debt to GDP ratio surging from 72.8 percent in 2019 to 88.7 percent in 2020. The increase was driven by the pandemic-induced economic contraction and the sizable fiscal measures to address the extraordinary emergency.

Definitions, Debt Profile and Vulnerabilities

- *Definitions and coverage*: Croatia's gross debt statistics cover the general government (central, local, social security funds and state-owned enterprises), and consists of liabilities in the following instruments: cash and deposits, debt securities and credits and loans.[2]

- *Debt profile and developments:* Central government debt accounts for 80 percent of general government gross debt. More than 95 percent of outstanding debt matures beyond one year (the average maturity of domestic bonds placed since 2019 has been about 10 years). Unlike the past, Croatia managed to borrow at longer maturity in sovereign bond markets, as the June 2020 11-year €2 billion Eurobond and the 12–20–year February 2021 €2 billion Eurobond have shown. About 71 percent of public debt is denominated in foreign currency (mainly euro-denominated). Euro denominated debt has decreased gradually during the last few years. Since its previous peak in 2014, public debt has declined more than 12 percentage points; and significant progress was made in the financial restructuring of the road sector which had contributed significantly to the build-up of debt in the past. Public debt reached an unprecedented 88.7 percent of GDP in 2020 and is estimated to decline to 87.6 percent of GDP in 2021. Gross financing needs almost doubled in 2020, as a result of the Covid-19 shock and subsequent policy support but are estimated to decline to 9.8 percent of GDP in 2021

[1] Prepared by Irina Bunda

[2] All SOE's debt is included in the statistics as they are part of the General Government definition. Note that Uljanik shipyards are not within the general government perimeter, as they are technically private companies (although they received state guarantees to help finance their investments in the past). The cost on these guarantees became part of the general government debt when the guarantees were called, and the state had to honor them. Other possible materialization of associated contingent liabilities is conceived as a future risk. On the main contingent liability item, healthcare arrears, estimated at about HRK 4.7 billion: HRK 2.6 bn have been cleared via spending reallocation within the 2021 revised budget (the remaining is assumed to be cleared over the next years).

(38 percent of general government tax revenues). Despite higher debt, average interest payments were generally lower given the decline in market interest rates. The CNB intervened in the currency market to ensure exchange rate stability and mitigated rising tensions in the government securities markets.

- *Debt management strategy*: High financing needs and exposure of sovereign debt to FX risks require sustained efforts to strengthen the debt management framework. The authorities' 2021–2023 debt management strategy aims at reducing debt-to-GDP by about 2 percentage points each year, and further lengthen the maturity of new issuances and reducing short-term debt and interest rate risk.

- *Realism of projections:* In the baseline projection, the primary budget deficit is expected to decrease over the projection horizon, relative to the 2020 level of 5.7 percent of GDP. The gradual improvement in the budget deficits over the projection horizon is driven by a withdrawal of pandemic support measures, a recovery in economic activity, increased availability and improved absorption of EU structural and RRF funds as well as related- spending rationalization measures (via structural reforms). At this point, the baseline includes only the consolidation measures that are already in place and assumes a gradually return of certain areas of current spending (in particular, the wage expenditures, social benefits, and subsidies) closer to their pre-pandemic levels over the forecast horizon. The baseline does not reflect the authorities' medium-term consolidation objective. The baseline thus projects a medium-term primary surplus of 0.2 percent of GDP, and a -percentage point reduction in debt-to-GDP from its 2020 peak. Taking into account the distribution of historical fiscal adjustment episodes provided in the DSA template, the projected three-year adjustment in the cyclically-adjusted primary balance of 3 percent of GDP is ranked in the 18 percentile of adjustment episodes, highlighting the relatively large size of the projected adjustment.

- *Vulnerabilities:* The heat map shows that the stock of debt and the gross financing needs remain high, and above the high-risk threshold. The debt profile has improved, relative to the 2019 vintage, in terms of market perception and change in the share of short-term debt. External financing needs continue to be relatively high. Non-residents' holding of public debt account for about 36 percent of total public debt (and foreign currency denominated debt for about 40 percent of total public debt, close to the upper early warning benchmarks. Total external gross financing needs are projected at about 49 percent of GDP in 2021 (See Annex III). However, the international reserve adequacy is above the ARA metric. Moreover, the banking system has net foreign assets (since 2016:Q1).

The Baseline Scenario Incorporates

- *Fiscal path*: Staff project a deficit of 4.1 percent of GDP for 2021, which continues to shrink as the recovery increases pace and fiscal adjustments resume. The structural balance is projected to be close to balance by 2026, the result of a 0.2 primary deficit on average per year during 2023–26.

- *Growth*: Real GDP growth is estimated at 5.4 percent for 2021, below the authorities' most recent estimate of 6 percent, while medium-term growth is expected to converge towards its potential rate of about 3 percent, below the authorities' projected 3.2 percent growth for 2024.

Risks to the baseline come mainly from potentially less favorable growth prospects, but the past track record of fiscal overperformance mitigates the balance of risks.

- While Croatia's real GDP growth forecast has been optimistic since 2009, errors have diminished in magnitude in recent years, and growth has even surprised on the upside. The growth shock could come from external risks), reflecting unexpected shifts in the pandemic, reduced demand from trading partners, higher commodity prices, and a protracted recovery of tourism activity as well as from idiosyncratic risks (higher frequency and severity of natural disasters related to climate change that could hit key infrastructure or disrupt trade).

- A negative interest rate-growth differential and the consolidation efforts could result in fast debt contraction, although the projected 2026 debt-to-GDP would still be above its pre-pandemic level. Gross financing needs are also projected to decline starting with 2022 due to lower deficits and recent refinancing of debt at longer maturities and favorable interest rates, resulting in lower effective rates even after accounting for a gradual normalization of global monetary conditions.

Shocks and Stress Tests

- **Slower output growth is the main risk to debt sustainability.** In the stress test scenarios, the public debt ratio is most sensitive to the real GDP growth shock. Underperformance of real GDP growth by one standard deviation leads to primary deficit sharply deteriorating by 5.7 percent of GDP and debt reaching 96.2 percent of GDP, before slowly improving thereafter (but remaining above 85 percent of GDP in the medium-term). This scenario also results in significantly increased public gross financing needs, peaking at 16.4 percent of GDP in 2023, 6.2 percentage points of GDP above the baseline gross financing needs for the same year and the gross financing secured in 2020.

- **A combination of macro-fiscal shocks further highlights the sensitivity of public debt and gross financing needs to adverse scenarios.** If shocks to real GDP growth, the primary balance, real exchange rate, and real interest rate were to occur simultaneously, public debt would increase sharply and reach nearly 98.6 percent of GDP (or about double public revenues) at its peak, without showing clear signals of a declining trajectory. Under this scenario, gross financing needs would go up to 17.2 in 2023 and progressively decline in the remaining years of the projection horizon.

Annex Figure II.1. Croatia: Public Sector Sustainability Analysis (DSA) – Baseline Scenario

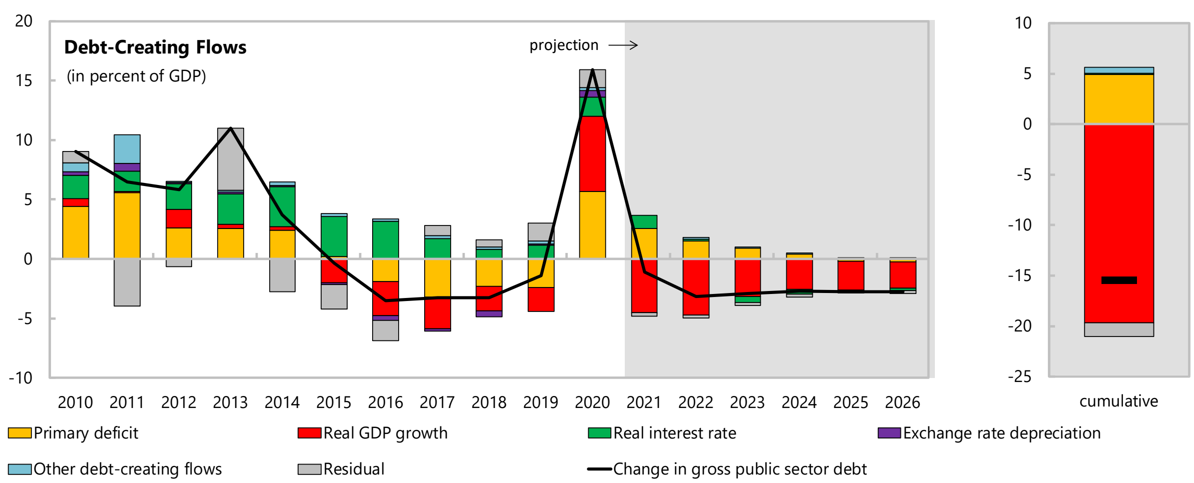
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections							As of July 23, 2021		
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026		Sovereign Spreads		
Nominal gross public debt	74.9	72.8	88.7	87.6	84.4	81.5	78.9	76.1	73.3		EMBIG (bp) 3/		93
Public gross financing needs	13.9	8.5	15.2	9.8	12.8	10.2	8.7	7.0	6.7		5Y CDS (bp)		78
Real GDP growth (in percent)	0.8	2.9	-8.0	5.4	5.8	4.0	3.3	3.2	3.1		Ratings	Foreig	Local
Inflation (GDP deflator, in percent)	0.9	1.5	0.5	0.7	1.5	2.2	2.1	1.5	1.7		Moody's	Ba2	Ba2
Nominal GDP growth (in percent)	1.7	4.4	-7.7	6.2	7.4	6.3	5.4	4.7	4.8		S&Ps	BBB-	BBB-
Effective interest rate (in percent) [4/]	4.2	3.1	2.5	2.1	1.8	1.6	1.6	1.4	1.4		Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing
Change in gross public sector debt	2.8	-1.4	15.9	-1.1	-3.2	-2.9	-2.7	-2.8	-2.8	-15.4	primary
Identified debt-creating flows	3.2	-2.9	14.4	-0.9	-2.9	-2.7	-2.5	-2.5	-2.6	-14.0	balance [9/]
Primary deficit	1.2	-2.4	5.7	2.6	1.5	0.9	0.4	-0.2	-0.2	4.9	-2.3
Automatic debt dynamics [5/]	1.6	-0.8	8.5	-3.4	-4.5	-3.7	-3.0	-2.5	-2.4	-19.5	
Interest rate/growth differential [6/]	1.6	-0.9	8.0	-3.4	-4.5	-3.7	-3.0	-2.5	-2.4	-19.5	
Exchange rate depreciation [7/]	0.0	0.1	0.5	…	…	…	…	…	…	0.0	
Other identified debt-creating flows	0.5	0.2	0.3	0.0	0.1	0.1	0.1	0.1	0.1	0.6	
Residual, including asset changes [8/]	-0.4	1.5	1.5	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-1.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex Figure II.2. Croatia: Public DSA Risk Assessment

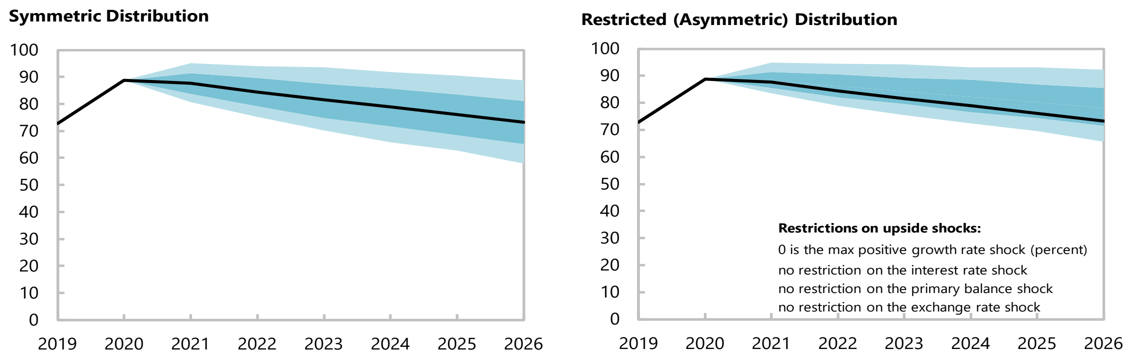
Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

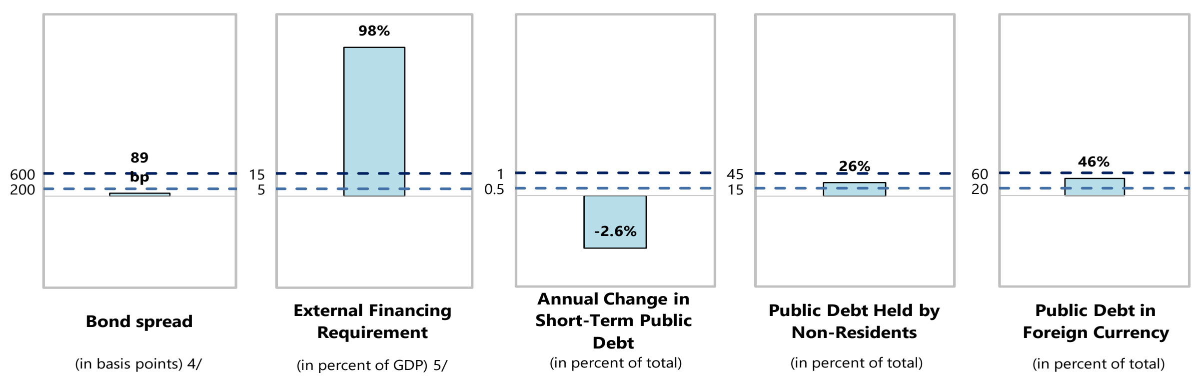
Baseline Percentiles: 10th-25th 25th-75th 75th-90th



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)

Croatia Lower early warning Upper early warning



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 24-Apr-21 through 23-Jul-21.

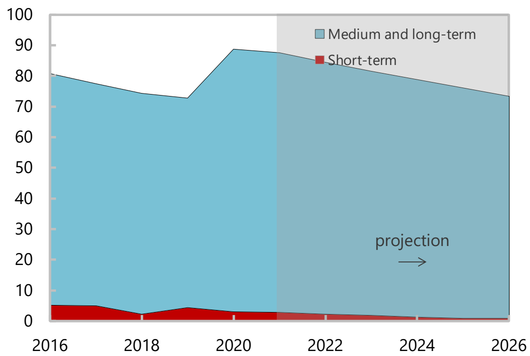
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex Figure II.3. Croatia: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

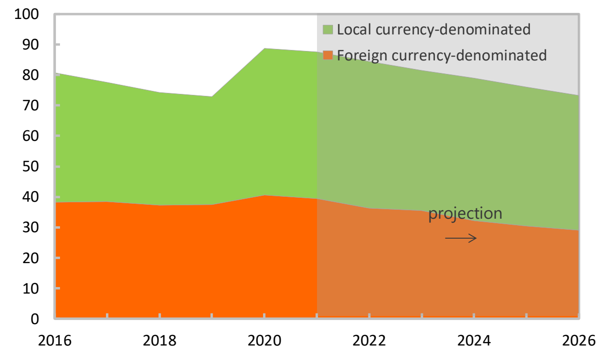
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

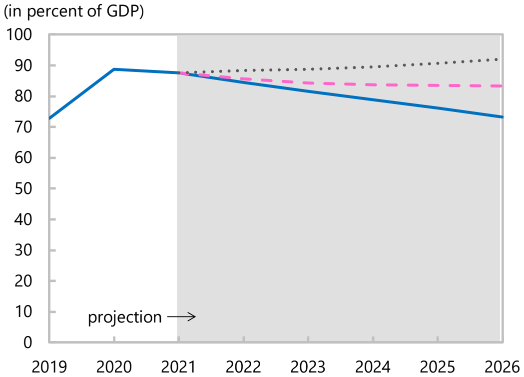


Alternative Scenarios

Baseline Historical Constant Primary Balance

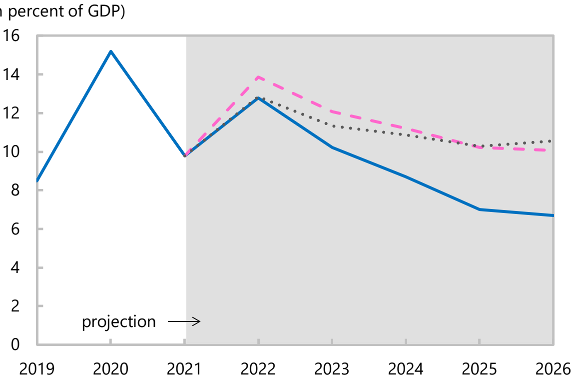
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

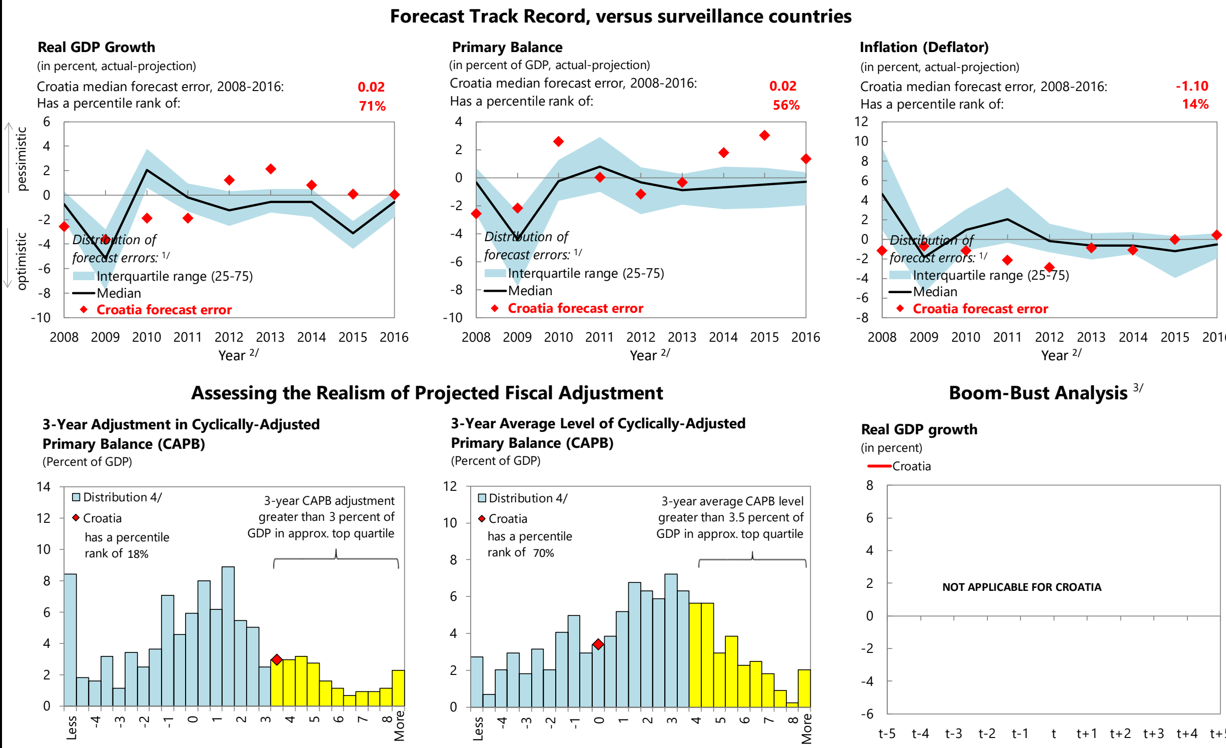
(in percent)

Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	5.4	5.8	4.0	3.3	3.2	3.1
Inflation	0.7	1.5	2.2	2.1	1.5	1.7
Primary Balance	-2.6	-1.5	-0.9	-0.4	0.2	0.2
Effective interest rate	2.1	1.8	1.6	1.6	1.4	1.4
Constant Primary Balance Scenario						
Real GDP growth	5.4	5.8	4.0	3.3	3.2	3.1
Inflation	0.7	1.5	2.2	2.1	1.5	1.7
Primary Balance	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	2.1	1.8	1.6	1.6	1.5	1.5

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	5.4	0.4	0.4	0.4	0.4	0.4
Inflation	0.7	1.5	2.2	2.1	1.5	1.7
Primary Balance	-2.6	-0.9	-0.9	-0.9	-0.9	-0.9
Effective interest rate	2.1	1.8	2.1	2.3	2.4	2.7

Source: IMF staff.

Annex Figure II.4. Croatia: Public DSA—Realism of Baseline Assumptions



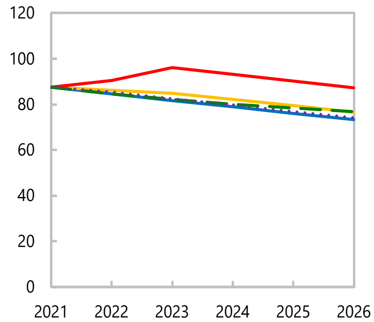
Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not Applicable for Croatia
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex Figure II.5. Croatia: Public DSA – Stress Tests

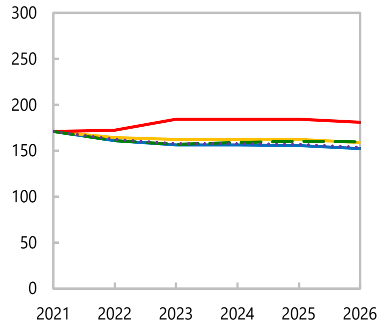
Macro-Fiscal Stress Tests

Baseline
Real GDP Growth Shock
Primary Balance Shock
Real Exchange Rate Shock
Real Interest Rate Shock

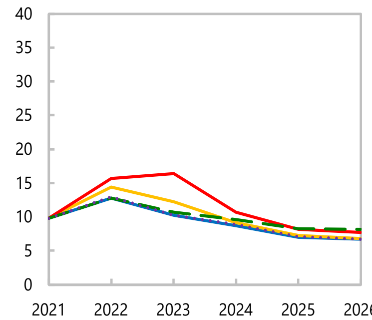
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



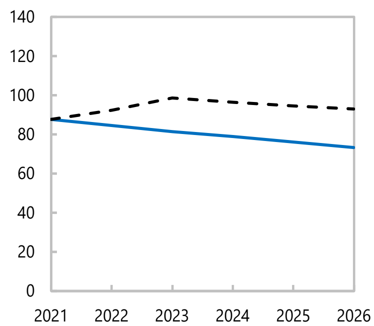
Public Gross Financing Needs
(in percent of GDP)



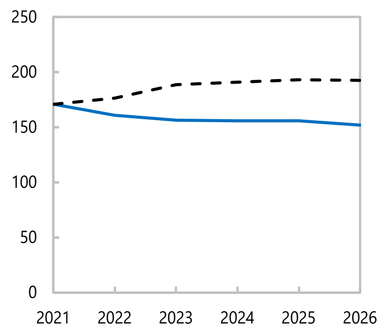
Additional Stress Tests

Baseline
Combined Macro-Fiscal Shock

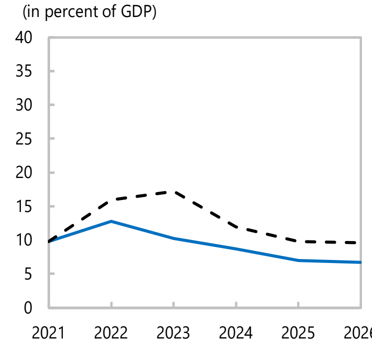
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

	2021	2022	2023	2024	2025	2026
Primary Balance Shock						
Real GDP growth	5.4	5.8	4.0	3.3	3.2	3.1
Inflation	0.7	1.5	2.2	2.1	1.5	1.7
Primary balance	-2.6	-3.1	-2.5	-0.4	0.2	0.2
Effective interest rate	2.1	1.8	1.7	1.7	1.5	1.6
Real Interest Rate Shock						
Real GDP growth	5.4	5.8	4.0	3.3	3.2	3.1
Inflation	0.7	1.5	2.2	2.1	1.5	1.7
Primary balance	-2.6	-1.5	-0.9	-0.4	0.2	0.2
Effective interest rate	2.1	1.8	2.3	2.6	2.8	3.2
Combined Shock						
Real GDP growth	5.4	2.2	0.4	3.3	3.2	3.1
Inflation	0.7	0.6	1.3	2.1	1.5	1.7
Primary balance	-2.6	-3.9	-5.7	-0.4	0.2	0.2
Effective interest rate	2.1	1.9	2.3	2.8	3.0	3.4

	2021	2022	2023	2024	2025	2026
Real GDP Growth Shock						
Real GDP growth	5.4	2.2	0.4	3.3	3.2	3.1
Inflation	0.7	0.6	1.3	2.1	1.5	1.7
Primary balance	-2.6	-3.9	-5.7	-0.4	0.2	0.2
Effective interest rate	2.1	1.8	1.7	1.9	1.7	1.7
Real Exchange Rate Shock						
Real GDP growth	5.4	5.8	4.0	3.3	3.2	3.1
Inflation	0.7	2.7	2.2	2.1	1.5	1.7
Primary balance	-2.6	-1.5	-0.9	-0.4	0.2	0.2
Effective interest rate	2.1	1.9	1.7	1.6	1.4	1.5

Annex III. External Debt Sustainability Analysis

Annex Table III.1. Croatia: External Debt Sustainability Framework, 2016–2026

(Percent of GDP, unless otherwise indicated)

		Actual							Projections						
		2016	2017	2018	2019	2020			2021	2022	2023	2024	2025	2026	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	95.8	88.4	81.9	74.2	81.3			**79.5**	**75.0**	**71.0**	**67.9**	**65.3**	**63.1**	**-4.5**
2	Change in external debt	-12.5	-7.4	-6.5	-7.7	7.0			-1.8	-4.4	-4.0	-3.1	-2.6	-2.2	
3	Identified external debt-creating flows (4+8+9)	-11.2	-10.9	-8.1	-12.7	6.4			-5.3	-4.9	-3.5	-3.3	-3.5	-3.6	
4	Current account deficit, excluding interest payments	-5.0	-5.7	-3.7	-3.5	-1.2			-0.1	0.6	0.7	0.2	-0.1	-0.1	
5	Deficit in balance of goods and services	-1.2	-0.7	0.8	0.2	6.7			6.4	5.7	5.2	4.2	3.9	3.5	
6	Exports	47.7	50.0	50.2	52.0	42.8			46.4	52.4	54.4	55.8	56.6	57.1	
7	Imports	46.5	49.3	51.0	52.2	49.5			52.8	58.1	59.6	60.0	60.5	60.6	
8	Net non-debt creating capital inflows (negative)	-4.3	-2.3	-1.7	-6.3	-1.4			-1.8	-1.8	-1.9	-1.9	-1.9	-1.9	
9	Automatic debt dynamics 1/	-1.8	-2.9	-2.7	-2.9	8.9			-3.4	-3.6	-2.2	-1.7	-1.5	-1.6	
10	Contribution from nominal interest rate	2.8	2.3	1.9	0.5	1.6			0.7	0.7	0.6	0.6	0.5	0.3	
11	Contribution from real GDP growth	-3.6	-3.1	-2.4	-2.2	6.6			-4.1	-4.3	-2.8	-2.2	-2.1	-1.9	
12	Contribution from price and exchange rate changes 2/	-1.0	-2.0	-2.3	-1.2	0.8			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	-1.3	3.6	1.6	5.0	0.7			3.5	0.5	-0.6	0.2	0.9	1.4	
	External debt-to-exports ratio (in percent)	200.8	176.9	163.2	142.6	190.1			171.2	143.3	130.4	121.8	115.5	110.6	
	Gross external financing need (in billions of US dollars) 4/	19.4	18.1	21.5	20.1	46.8			25.5	26.2	25.0	24.9	24.8	17.5	
	in percent of GDP	41.6	36.8	41.4	37.0	95.0	10-Year	10-Year	48.7	46.6	41.9	39.6	37.6	25.4	
	Scenario with key variables at their historical averages 5/								**79.5**	**76.5**	**73.0**	**70.2**	**67.7**	**66.0**	**-1.4**
							Historical	Standard							
	Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
	Real GDP growth (in percent)	3.5	3.4	2.8	2.9	-8.0	0.4	3.6	5.4	5.8	4.0	3.3	3.2	3.1	
	GDP deflator in US dollars (change in percent)	1.0	2.1	2.6	1.5	-1.1	0.6	1.2	0.7	1.5	2.2	2.1	1.5	1.7	
	Nominal external interest rate (in percent)	2.7	2.5	2.2	0.6	1.9	2.5	0.8	0.9	0.9	0.8	0.8	0.8	0.5	
	Growth of exports (US dollar terms, in percent)	7.3	10.7	6.0	8.2	-25.3	3.1	10.5	15.2	21.1	10.5	8.0	6.2	5.7	
	Growth of imports (US dollar terms, in percent)	5.3	12.0	9.3	6.9	-13.9	3.9	7.3	13.2	18.0	9.2	6.0	5.6	5.0	
	Current account balance, excluding interest payments	5.0	5.7	3.7	3.5	1.2	3.5	1.9	0.1	-0.6	-0.7	-0.2	0.1	0.1	
	Net non-debt creating capital inflows	4.3	2.3	1.7	6.3	1.4	2.4	1.7	1.8	1.8	1.9	1.9	1.9	1.9	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

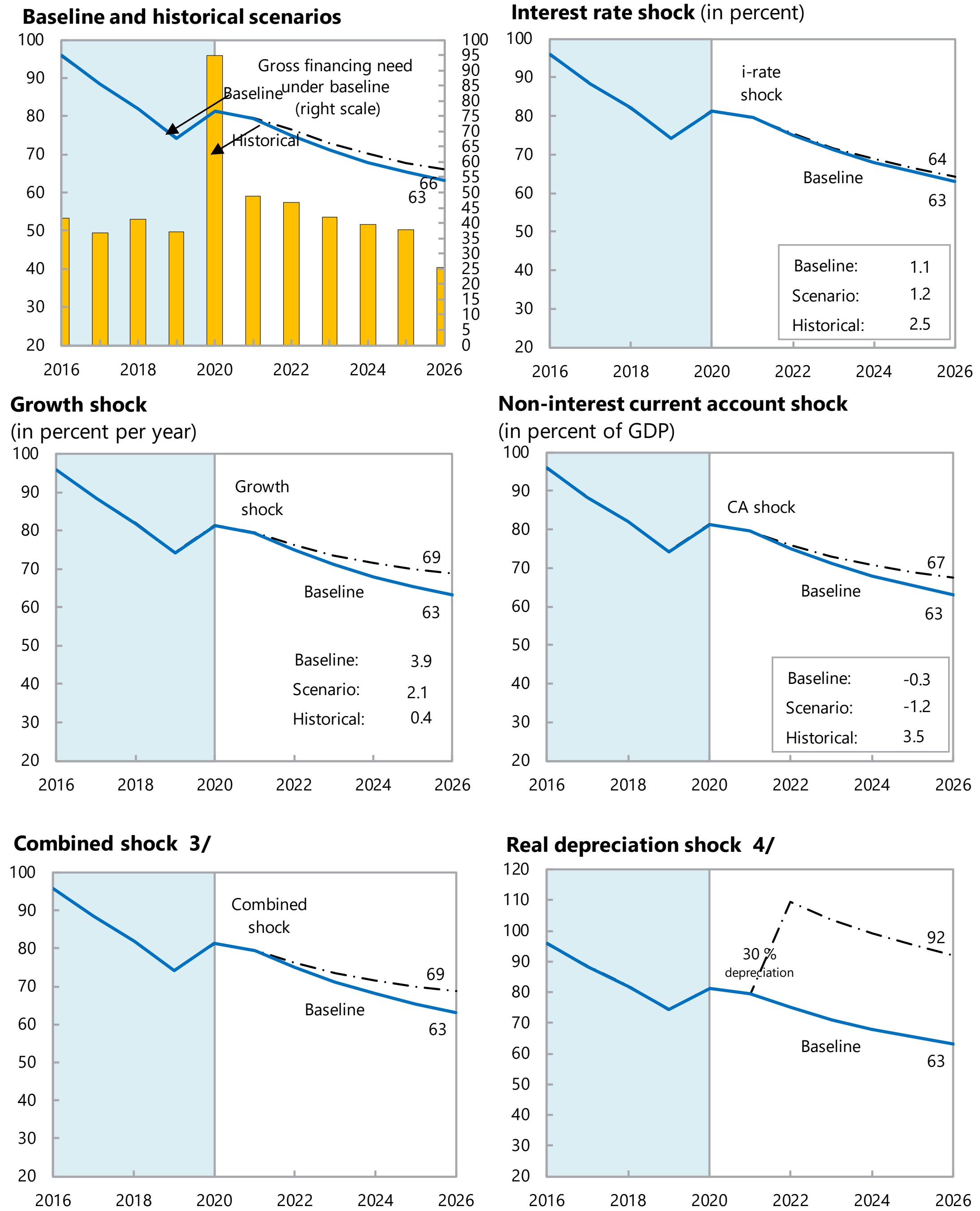
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex Figure III.1. Croatia: External Debt Sustainability: Bound Tests of the Baseline Scenario 1/ 2/

(External Debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2022.

Annex IV. External Sector Assessment[1]

Overall Assessment: *The external position of Croatia in 2020 was broadly in line with the level implied by fundamentals and desirable policies. The current account (CA) balance turned negative in 2020 due to collapsed tourism and services exports in the wake of the pandemic. Over the medium term, the current account deficit is set to recover and return to the pre-pandemic level.*

Potential Policy Responses: *Short-term policies should focus on containing the Covid-19 outbreak and its economic consequences and provide relief to households and firms. The recent Covid-19 crisis initiatives both at the national and EU-levels will support these efforts of recovery. Polices to support tourism would help the recovery pace when the pandemic recedes. Structural reforms to raise productivity and enhance competitiveness will help to improve the external position further.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Overall external indebtedness as share of GDP increased to 81.3 percent in 2020, while the gross external debt in nominal terms continued to decline. The gross debt of the central bank and other sectors decline in nominal terms, as the government, banks and direct investment increased. The NIIP improved from -58 percent of GDP in 2018 to -50 percent in 2019 before the pandemic. The NIIP is remaining around -51 percent of GDP in 2020.

Assessment. External vulnerabilities have been reduced with the strengthening of the NIIP in recent years. The NIIP is substantially stronger than in 2010 when the NIIP stood at around -94 percent of GDP. The improvement was due to sustained current account surpluses, EU funds absorption, and GDP growth before the pandemic. Thus, the current path of the NIIP does not imply risks to external sustainability or a need for substantial adjustment.

2020 (% GDP)	NIIP: -51	Gross Assets: 72	Debt Assets: 48	Gross Liab.: 123	Debt Liab.: 80

Current Account

Background. The overall current account (CA) balance turned negative in 2020 from continuous CA surpluses since 2014. The overall CA deficit was -0.4 percent of GDP in 2020 mainly due to collapsed services exports in the wake of the pandemic, compared to 3.0 percent of GDP in 2019. The services balance worsened reflecting significantly lower tourism exports. Owing to the pandemic, overall balances on goods and services declined from -0.2 to -6.7 percent of GDP, with exports of goods (plus services) at 24.7 (42.8) percent of GDP and import of goods (plus services) at 42.2 (49.5) percent of GDP in 2020. In 2021, the current account balance is projected to be at about -0.6 in 2021, as the recovery continues. Over the medium term, the current account is projected to move towards small deficit, as growth in tourism receipts recover while imports remain strong in line with stronger consumption and investment under the Next Generation EU projects.

Assessment. The current account is broadly consistent with fundamentals and medium-term policies in 2020. The CA registered a deficit of 0.4 percent of GDP. Adjusting for cyclical contributions, Covid-19, and natural disasters, the adjusted CA is estimated to be -0.8 percent against the EBA-lite derived CA norm of -1.5 percent. The residual was small. Accounting for estimated recovery of tourism as well as the EU accession, a multilaterally consistent cyclically adjusted CA norm is estimated to be -1.5 percent of GDP. The CA gap is thus computed as 0.7 percent of GDP.

[1] Prepared by Grace B. Li

Croatia: Model Estimates for 2020 (in percent of GDP)

	CA model	REER model	ES model
CA-Actual	**-0.4**		
Cyclical contributions (from model) (-)	0.6		
COVID-19 adjustor (+) 1/	-0.2		
Natural disasters and conflicts (-)	-0.4		
Adjusted CA	**-0.8**		
CA Norm (from model) 2/	**-1.5**		
Adjustments to the norm (+)	0.0		
Adjusted CA Norm	**-1.5**		
CA Gap	**0.7**	**-2.1**	**4.3**
o/w Relative policy gap	1.3		
Elasticity	-0.37		
REER Gap (in percent)	**-1.9**	**5.6**	**-11.6**

1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism.
2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. In 2019, the CPI-based REER depreciated from their 2018 levels by 1.5 percent. In 2020, the CPI-based REER depreciated by 0.7 percent relative to its 2019 value.

Assessment. The various models yield mixed empirical results regarding the kuna's valuation. The REER gap implied by the CA model implies a slight undervaluation of 1.9 percent (after adjustments). The REER index model suggests an overvaluation of 5.6 percent. The external sustainability (ES) approach assesses the REER to be undervalued by almost 11.6 percent. However, since the NIIP is better than -60 percent of GDP and headed to -50 percent of GDP over the medium-term, staff does not view external sustainability as a concern.

Capital and Financial Accounts: Flows and Policy Measures

Background. The capital and financial account increased by 3.4 percentage points of GDP in 2020. The capital account increased by 0.6 percent of GDP while the financial account improved by 2.8 percent of GDP.

Assessment. Owing to the pandemic, the external debt increased to 81.3 percent of GDP; however, it is projected to come down with the recovery. The government has been able to borrow on favorable terms given ample global liquidity and good ratings. Croatia remains the position of low financial vulnerability.

FX Intervention and Reserves Level

Background. In 2020, gross official reserves continued to increase gradually to €18.9 billion. Reserves are projected to increase to nearly €26.6 billion in 2026 under the baseline scenario. This also incorporates the adjustment of the SDR allocation of USD 980 million to be kept in reserves from 2021.

Assessment. This increase kept official reserves above the ARA metric in 2020 and improved the already comfortable margins relative to short-term debt as well as a ratio of months of next year's imports of goods and nonfactor services.

Annex V. Risk Assessment Matrix[1]

	Source of Risks/Time Frame/Relative Likelihood	Impact if realized	Recommended policy response
Conjunctural shocks and scenarios	**Uncontrolled Covid-19 local outbreaks and subpar/volatile growth in affected countries. High**	***Medium to High*** ▪ Outbreaks in slow-to-vaccinate countries force new lockdowns. For many Emerging Markets and Low-Income Countries, policy response to cushion the economic impact is constrained by lack of policy space, with some market access countries facing additional financial tightening as a reassessment of growth prospects triggers capital outflows, depreciations, and debt defaults.	Accelerate deployment of vaccines, reinstate Covid-19 support measures; accelerate healthcare reforms; Improve competitiveness to reduce scarring; Improve labor market flexibility to deal with losses in employment and income; Conserve resources through better targeting of social benefits and restraint with public wage bill growth; Employ ALMPs more actively to enable more youth employment. Build reserve buffers.
	Global resurgence of the Covid-19 pandemic. Medium	***Medium to High*** ▪ Local outbreaks lead to a global resurgence of the pandemic (possibly due to vaccine-resistant variants), which requires costly containment efforts and prompts persistent behavioral changes rendering many activities unviable.	
	Disorderly transformations. Medium	***Medium*** ▪ Covid-19 triggers structural transformations, but the reallocation of resources is impeded by labor market rigidities, debt overhangs, and inadequate bankruptcy resolution frameworks. This, coupled with a withdrawal of Covid-19-related policy support, undermines growth prospects, and increases unemployment, with adverse social/political	Improve labor market flexibility; Employ ALMPs more actively. Use flexible fiscal measures to facilitate structural transformation. When health risks diminish and a durable recovery is foreseeable, support should shift from protecting employee-firm relationships to helping

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Conjunctural shocks and scenarios		consequences. Adjustments in global value chains and reshoring (partly driven by geostrategic and national security concerns) shift production activities across countries.	workers find new jobs, helping viable but still-vulnerable firms reopen, and supporting structural transformation toward the post-pandemic economy.
	De-anchoring of inflation expectations in the U.S. leads to rising core yields and risk premia. Medium	***Medium to High*** ▪ A fast recovery in demand (supported by excess private savings and stimulus policies), combined with Covid-19-related supply constraints, leads to sustained above-target inflation readings and a de-anchoring of expectations. The Fed reacts by signaling a need to tighten earlier than expected. The resulting repositioning by market participants leads to a front-loaded tightening of financial conditions and higher risk premia, including for credit, equities, and emerging and frontier market currencies.	Continue sustainable fiscal consolidation by more efficient government spending and revenue collection; Use FX intervention if necessary, to counter disorderly market conditions. Encourage further development of hedging instruments.
	Widespread social discontent and political instability. Medium	***Low*** ▪ Social tensions erupt as a withdrawal of pandemic-related policy support results in unemployment and, amid increasing prices of essentials, hurts vulnerable groups (often exacerbating pre-existing inequities).	Clearly communicate the pros of the vaccine roll-out. Accelerate visible reforms in the healthcare sector; Improve the flexibility of the labor market to deal with losses in employment and income; Efforts to formalize and reactivate vulnerable groups.
	Rising commodity prices amid bouts of volatility. Medium	***Medium*** ▪ Commodity prices increase by more than expected against a weaker U.S. dollar, post-pandemic pent-up demand and supply disruptions, and for some materials, accelerated plans for renewable energy adoption. Uncertainty surrounding each of these factors leads to bouts of volatility, especially in oil prices.	

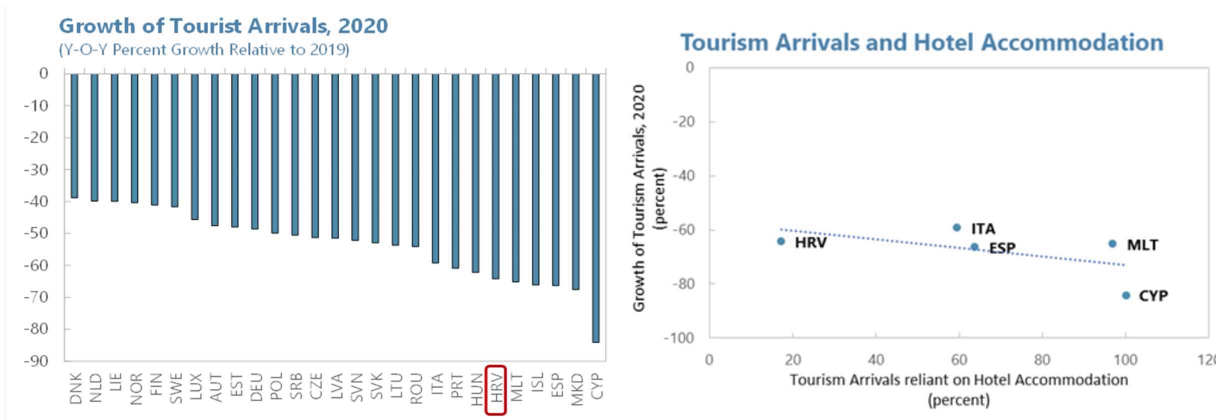
Structural	**Intensified geopolitical tensions and security risks. High**	***Medium to Low*** ▪ Geopolitical tensions in selected countries/regions cause economic/political disruption, disorderly migration, higher volatility in commodity prices (if supply is disrupted), and lower confidence, with spillovers to other countries.	Continue fiscal consolidation and build buffers.
	Cyber-attacks Medium	***Medium to Low*** ▪ on critical infrastructure, institutions, and financial systems trigger systemic financial instability or widespread disruptions in socio-economic activities and remote work arrangements.	Continue to reduce cyber risks.
	Higher frequency and severity of natural disasters related to climate change Medium	***High*** ▪ Cause severe economic damage to smaller economies susceptible to disruptions and accelerate emigration from these economies (medium probability). A sequence of severe events in large economies reduces global GDP and prompts a recalculation of risk and growth prospects. Disasters hitting key infrastructure or disrupting trade raise commodity price levels and volatility (low probability). Croatia is exposed to natural disaster and climate risks. Devastating earthquakes can also occur.	Build fiscal buffers; Implement the RFF green investments to stem climate change; continue to invest in climate transition. Implement the recommendations of the upcoming PIMA/ Climate module.

Domestic	**Lower and inefficient absorption of EU funds/Medium term/ Medium**	***High*** ▪ Growth will be adversely impacted by slow absorption of growth-enhancing investment.	Accelerate reforms to improve absorption, e.g. PIMA, and invest on new technologies and improve labor force skills
	Erosion of the fiscal stance/Short term/ Medium	***Medium*** ▪ Add to deficit in structural forms, lead to slowdown in reducing public debt and prolong the convergence program.	Improve efficiency of government spending and revenue collection. Resist calls to increase wages and benefits not based on productivity gains; Avoid extending further tax exceptions and concessions.
	Further reform standstill/ Medium term/ Medium	***Medium*** ▪ If promised reforms are not delivered, it will affect growth through lower investment, and labor productivity.	Use the opportunity ahead of the ERMII accession and strengthen national commitments to reform.
	Negative demographics/Short to medium term/High	***Medium*** ▪ Aging will continue to impact the labor force, wages, and the sustainability of social welfare system.	Structural reforms that will increase productivity and thus real wages; Further reform the labor market; Increase the labor force participation; Invest in improving human capital.

Annex VI. Tourism Outlook and Perspectives[1]

Tourism in Croatia has taken a hard hit from COVID-19. Travel restrictions led to a significant decrease in tourism demand from the major markets. Under several rounds of lockdowns, tourism arrivals declined by 64 percent y-y in 2020. The decline in employment has been contained thanks to the job retention scheme.

Annex Figure VI.1. Croatia: Tourism Characteristics



Source: Eurostat.

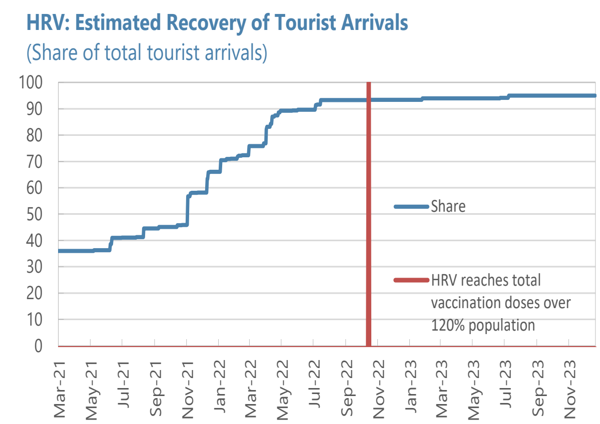
Croatian tourism has some uniquely advantageous features. Almost 90 percent of Croatian tourist arrivals and over 95 percent of night stays are from Europe. International tourists from nearby EU Member States tend to arrive in Croatia by car, which is more than 90 percent of international tourists. Its geographical location gives it ease of accessibility from key EU source countries (Germany, Austria, Slovenia). Croatia hopes to join the Schengen area as soon as next year. Furthermore, the country's excellent road networks make it less dependent on airline travel. Given the fall in attractiveness in hotels with the pandemic, non-hotel accommodation has great potential to attract tourists. In Croatia, less than half of tourists stay in hotels and similar accommodations, with stays less concentrated in large urban areas. These favorable factors could help Croatia recover relatively faster than many other peer economies with high tourism-dependence.

Indeed, initial signs are encouraging. According to the Croatian National Tourist Board, there were 2.6 million tourism arrivals and 11.8 million overnights in Croatia during the first six months of 2021. This is about 54 percent more tourism arrivals and 53 percent more overnights than in the same period last year. In addition, the recovery in its tourist source countries, including Germany, UK, and other European countries would also help the tourism in Croatia.

[1] Prepared by Grace. B. Li and Irina Bunda, drawing on Liu, Bunda, and Salas (2021), "Tourism in Europe: Timeline for Recovery and Sectoral Spillovers," EUR webinar presentation, June 6.

The recovery of tourism is likely to be associated with the pace of vaccination rollout and global travel restrictions. Based on the current pace of vaccination rollout in Croatia and the main source countries, staff projects a recovery of 66 percent of the 2019 tourist arrivals level by end–2021 and a close-to-full recovery taking place by end–2022. This methodology provides an anchor of the timeline of tourism recovery, reliant on vaccination progress (linear projection based on existing speed). The timeline of tourist arrivals is estimated based on vaccination speed in tourist source countries, and the share of tourists by each source country. However, this projection is still subject to large global uncertainty.

Annex Figure VI.2. Croatia: Tourism Forecast



There are broader implications of continued weak activity in tourism-related sectors, which can be captured via a spillover analysis. The focus of the analysis is on the production linkages captured in the OECD input-output tables for Croatia. The sectors most closely related to tourism include *"accommodation and food services (S25)"* and *"transportation and storage (S24)"*. The latter encompasses land, water and air transport, as well as warehouses and support activities for transportation, and postal and courier activities.[2] First, the spillovers on the aggregate economy can be quantified based on demand shocks (i.e., shocks to final demand for tourism-related sectors) and supply shocks (i.e., shocks to those sectors as suppliers of intermediate inputs). Second, the insights from cross-sector linkages can be connected with the forecast timelines of tourism recovery, to quantify what these forecasts imply for activity in tourism-related sectors, and "project" the aggregate economic impact. This can be seen and as an analysis of "scarring" due to depressed tourism levels.

The link between low numbers of tourists and weakness in demand for tourism-related services is further investigated. A regression analysis of gross output elasticity to foreign tourist arrivals in Croatia finds elasticities of about 0.24 for S24 and S25. The timeline of tourism recovery in Croatia can then be combined it with the previous I-O analysis to estimate a measure of "aggregate scarring" from a gradual recovery of demand in tourism-related sectors. At end 2023, the lingering impact is expected to be 0.2 percent below 2019 (Figure 3).

Fiscal support measures helped the sector during the pandemic. Twenty thousand people in the tourism industry were covered by job preservation measures, and some targeted measures were

[2] Other relevant sectors are *"other business sector services (S31)"* (which includes "travel agency, tour operator, reservation service and related activities" and "renting and leasing of motor vehicles", among other non-tourism-related services) and *"arts, entertainment, recreation and other service activities (S34)"* (which includes "creative, arts and entertainment activities" as well as "museums", along with other subsectors often less related to tourism such as "gambling and betting").

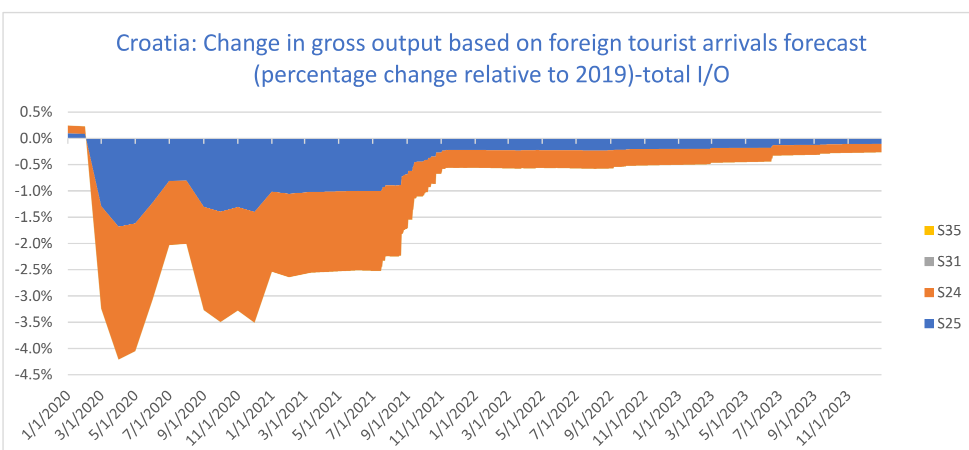
also implemented. The preexistent measure provides the job support to the permanent seasonal workers (50,000 people), including a subsidy of the employer-covered pension contributions during the time of inactivity. During the pandemic, the standard eligibility criteria were relaxed, and the support had been increased to a full coverage of the six months following the last day of activity. Among EU high-tourism dependent countries, Croatia has also implemented a range of other non-fiscal policies. Moratorium policies provided delay of loan and rent payments. Lending support (i.e. guarantees, interest subsidies), as well as in many other EU high-tourism countries, are more targeted to tourism.

Going forward, policy measures should shift toward rebuilding more sustainable and resilient tourism model. The adoption of the Strategy for the Development of Sustainable Tourism by 2030 along three axes: socio-economic sustainability, environmental and territorial sustainability is planned by 2022Q3. The strategy will also focus on the issue of land use so far, i.e. over-tourism in individual destinations, as one of the key problems of tourism development, and provide a response to how to better promote the reduction of uneven regional development in Croatia. At the same time, public calls for the green and digital transition of existing public tourism infrastructure and the development of public tourism infrastructure beyond the main tourist and coastal areas will be launched.

Better monitoring of tourism sector developments is another prerequisite for sustainable tourism. By end-2023, the NRRP includes setting up of a Sustainable Tourism Satellite Account as well as the adoption of the Tourism Act. The latter will provide a framework for the monitoring and development of the tourism sector through the establishment of a data monitoring and analysis system, monitoring and analysis of investments, and the definition of indicators and standards for ensuring the sustainability of tourism (in particular green and digital standards). Finally, by end–2024, educational programs are planned to be developed to strengthen tourism knowledge and skills, including digital skills and related to green construction, renewable energy, innovative products, entrepreneurial skills, and sustainable destination management.

Annex Figure VI.3. Croatia: Economic "Scarring" Based on the Timeline for Tourism Recovery (Total I-O)

where S25=Accommodation and Food; S24=Transportation and Storage



Source: Liu, Bunda, and Salas (2021), "Tourism in Europe: Timeline for Recovery and Sectoral Spillovers," EUR webinar presentation, June 6.

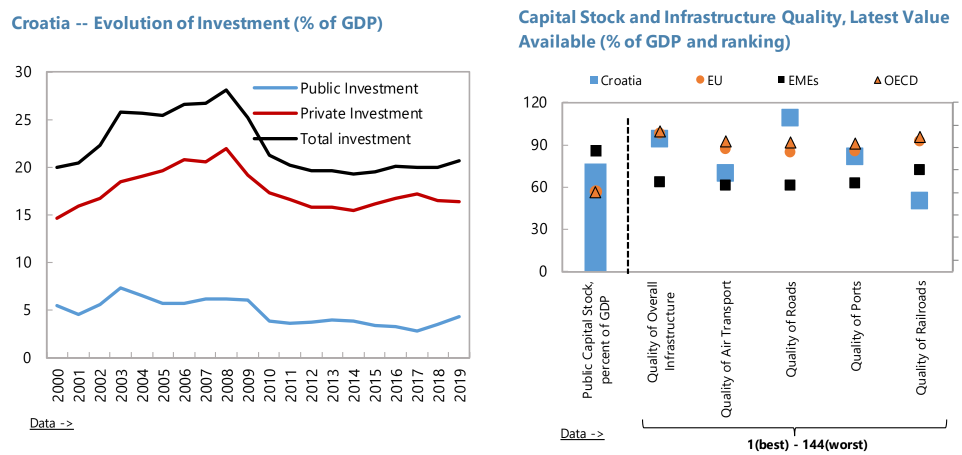
Annex VII. Selected Structural Reforms Included in the NRRP

- National Health Development Plan 2021–2027 (2021:Q3)
- New Inland Navigation and Ports Act and new Regular and Seasonal Coastal Traffic Act (2021:Q3)
- Reorganization of the railway companies and business management (2024:Q4)
- Improve and harmonize the quality of healthcare by developing Clinical e-Guidelines (2025:Q3)
- Reduction of the administrative burden directly affecting citizens, through digitalization and simplification of procedures (2025:Q4)
- Education vouchers (2026:Q2)
- Adoption of the Act on the institutional framework for EU funds (2021:Q4)
- New Croatian Government Decision adopted on SOEs of particular interest to Croatia (2021:Q4)
- Ensure the full functionality of the Fiscal Policy Commission and strengthening the fiscal framework through the adoption of the Budget Act to improve the budgetary processes (2021:Q4)
- Supplement active labor market policies and developing skills according to market needs (2022:Q1)
- New Act on Agricultural Land Consolidation (2022:Q1)
- Amendment of the legislative frameworks to encourage the voluntary functional or actual merger of the local government units (LGUs) (2022:Q1)
- Publication of an assessment document with recommendations to alleviate barriers and administrative procedures restraining to higher uptake of renewable energy sources (2022:Q2)
- Adoption of the new Act on Scientific Activity and Higher Education (2022:Q3)
- Adoption of the Health System Performance Assessment Framework (HSPA) (2022:Q3)
- Adoption of the Strategy for the Development of Sustainable Tourism by 2030; Launch public calls for the green and digital transition of existing public tourism infrastructure and the development of public tourism infrastructure beyond the main tourist and coastal areas (2022:Q3)
- Entry into force of legislation and/or regulation to improve uptake of renewable energy sources, including introduction of a premium-based system for the support of renewable energy sources (2022:Q4)
- Amendments to the legal framework in the water sector(2022:Q4)
- National Plan for the Development of Railway Infrastructure, the National Management Plan for Railway Infrastructure and Service Facilities; new Maritime Domain and Seaports Act (2022:Q4)
- "Digital Strategy for Croatia 2030" (2022:Q4)
- Adoption of the Law on Tackling Undeclared Work and the new Labor Law (2022:Q4)
- Amendment of the Health Care Act and Compulsory Health Insurance Act (2022:Q4)
- Adoption of the Strategy for the Evaluation of the Economic Effects of Regulation on the SME sector by the Croatian Government and the accompanying Action Plan (2022:Q4)
- Adoption of amendments to the Pension Insurance Act (2023:Q1)
- Entry into force of Acts on salaries in the state administration and public services (2023:Q2)
- Entry into force of the Act amending the State Assets Act, which shall provide a legal basis for the complete separation of the management of the gas transmission system operator (Plinacro) from state-owned production and supply activities (2023:Q4)
- Entry into force of the amendments to the Labor Market Act (2023:Q4)
- Functional integration of hospitals and joint procurement procedure for health institutions (2023:Q4)
- Tourism Act establishing a framework for monitoring and development of the tourism sector (2023:Q4)
- New legal framework on SOEs, incorporating the OECD's recommendations (2024:Q1)
- Establish a strategic framework for the promotion of private investment; simplification or removal of at least 50 regulatory requirements for professional services; amend and supplement the legal framework for R&D tax incentives (by 2024:Q4)
- Realization of the sale of 90 state-owned enterprises which are not of particular interest to the Republic of Croatia and are managed by CERP (2026:Q2)

Annex VIII. Enhancing the Efficiency of Public Investment in Croatia

Croatia has a high per capita stock of public capital due to good transportation infrastructure (especially roads), and investments in port renovation. Still, Croatia has room to improve air and railroad infrastructures (Text Figure). Croatia places well in terms of availability of currently "mainstream" technologies (e.g., fixed broadband and mobile phones) but needs to improve readiness for newer technologies. Croatia ranks 4th last in Europe in the 2020 DESI connectivity index that measures the deployment of communications infrastructure and its quality. Past Article IV reports have encouraged more public investment in ICT and new technologies to enhance digital competitiveness. Croatia has worked to attract private sector involvement in infrastructure development and has invested in devising a PPP framework to attract investment.

Croatia: Investment Developments



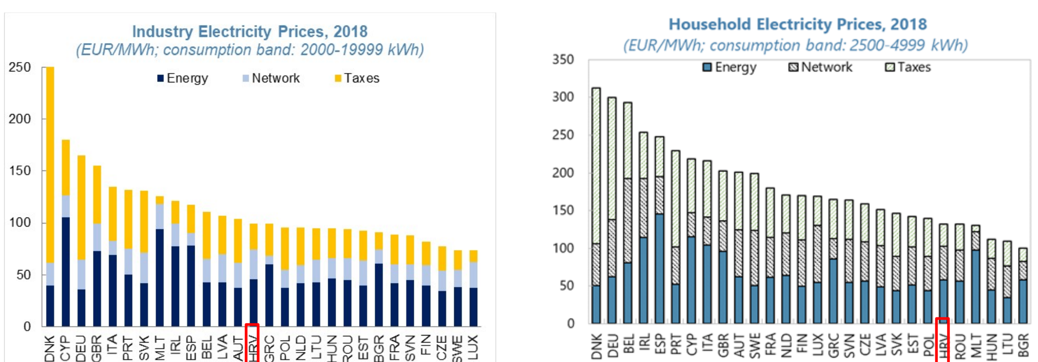
Sources: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook, Development Indicators, IMF Investment and Capital Stock Dataset, and World Economic Forum.

Croatia needs greater public investment in green and digital infrastructure. Effectively investing EU funds is paramount. Croatia will have access to grants of EUR 6.3 billion and loans of EUR 3.40 billion. A prerequisite for the use of funds from the RRF is the submission of the final National Recovery and Resilience Plan 2021–2023 to the EC in the Spring. The Plan includes reforms and investments that will need to be undertaken no later than end-August 2026. 30 percent of RRF investments are directed toward the private sector. It is expected that Croatia receives advanced payments between EUR [750 and 800] million, or [13] percent of available grants, by the end of this summer. This is in addition to [€12.7] billion intended for development, coming from the EU Multiannual Financial Framework (MFF) and [€683] million from the EU Solidarity Fund, for the reconstruction of Zagreb after the devastating March 2020 earthquake—these are for the regular seven year cycle 2021–27. Delivering all future investments in a way that maximizes efficiency and impact will require improvements in public investment management across government.

Croatia is exposed to natural disaster and climate risks. Croatia is at risk of meteorological hazards and natural disasters, which primarily affect the agricultural, water, and energy sectors through seasonal flooding, decreased precipitation, and periods of drought. Sea level rise has the potential to influence use of the coasts and many islands of Croatia. Devastating earthquakes can also occur, with the recent 2020 Zagreb (March) and Banovina region (December) earthquakes causing an estimated €16.6 billion in damage (34 percent of 2020 GDP). Croatia has identified agriculture, forestry, biodiversity, energy, water resources and tourism as its adaptation priorities (WB Climate Knowledge Portal).

Croatia would also benefit from adopting carbon pricing and complementary policies: (i) review subsidies to large energy-intensive firms; (ii) Green public R&D and efficiency spending; (iii) subsidies and other support for climate-friendly private investments; and (iv) remove regulatory hurdles to spur green investments. Electricity networks could also be upgraded to facilitate the expansion of renewables (intermittent/decentralized electricity supply, increase coverage and interconnection of electricity grids, and facilitate the electrification of downstream sectors. Invest in green technologies going forward (smart grids, storage systems (e.g. power to gas), carbon capture & storage) (Arregui et al, 2020).[1] (Text Figures).

EU: Electricity Prices



Source: Eurostat.

Source: Eurostat.

In the NRRP, the measures supporting climate objectives account for 40.3 percent of the plan's total allocation. The plan includes reforms and investments contributing to the green transition, including investment in energy efficiency through renovation of the public and private buildings stock, reforms to facilitate the deployment of renewable energy sources, investments in geothermal energy, and in the electricity and distribution grid to facilitate the integration of renewable energy sources. Investments into carbon capture and geological storage have climate mitigation potential. In addition, the NRRP supports deployment of advanced biofuels, production of renewable hydrogen and roll-out of refueling infrastructure which will all foster a shift to sustainable mobility in the next decade. It promotes the modal shift from road to rail, while investing into zero-emission vehicles and vessels and in supporting the related infrastructure.

[1] Nicolas Arregui, Ruo Chen, Christian Ebeke, Jan Frie, Daniel Garcia-Macia, Dora Iakova, Andreas Jobst, Louise Rabier, James Roaf, Anna Shabunina, and Sebastian Weber, 2020, "EU Climate Change Mitigation: Sectoral Policies," EUR Departmental Paper Series, No 20/4.

Annex IX. Monetary Policy During Covid-19[1]

The CNB swiftly and successfully introduced measures to mitigate the pandemic. *The CNB pursued a highly expansionary monetary policy, while maintaining exchange rate stability with liquidity reaching historical high levels and short money market rates close to zero.*

The Covid-19 shock triggered pressures on the exchange rate, the government securities markets, and concerns about adequate liquidity. Conversion to FX when perceived risks and uncertainties increase is usual in Croatia. Moreover, tourism—an important FX source—would obviously take a hit. In addition, portfolio rebalancing of investment funds, together with envisaged increased funding needs of the government, triggered pressures in the government securities market. Finally, there were concerns about liquidity constraints due to continued expenditures but declining incomes by corporations, households, and the government. The CNB measures focused on:
(i) maintaining the kuna/euro exchange stability and securing sufficient foreign exchange;
(ii) increasing kuna liquidity at low interest rates to enable banks to continue lending; and
(iii) mitigating the dysfunction of the government securities market.

FX interventions at the beginning of the pandemic amounted to about 5.5 percent of GDP. They were primarily done as large FX auctions (4.6 percent of GDP), but also smaller bilateral interventions. They took place from mid-March to mid-April. FX pressures quickly abated when the €2 billion swap agreement with the ECB was announced on April 15, 2020. It appeared to have a significant calming influence on markets. Furthermore, ERM II membership was announced on July 10, 2020,[2] and it became clear that Croatia would receive substantial amounts of EU funds. International reserves quickly recouped: largely due to CNB purchases of euro from the Ministry of Finance, but also because outflows at the beginning of the pandemic soon reversed (Figure). In late 2020, the CNB again intervened, but to contain appreciation pressures. In April and in June 2021, the CNB, respectively sold and purchased relatively modest amounts of FX from banks to ensure exchange rate stability.

The CNB conducted five large transactions in the secondary government securities market and purchased long government securities for almost 5.5 percent of GDP (market value, 4.9 percent of GDP in nominal value). The tension was primarily related to portfolio rebalancing by investment funds. After the first auction on March 13, 2020, the list of eligible participants was broadened from credit institutions to non-bank financial institutions licensed by the Croatian Financial Services Supervisory Agency for non-bank financial institutions. Like other emerging markets, Croatia did also experience some minor outflows of ETF (exchange-traded-funds) and mutual funds, which soon reversed. In line with ECB requirements, the purchases were conducted in the secondary market, and in line with ECB guidance, the CNB did not buy more than 1/3 of the outstanding amount of each issuance. These rules and the purpose of the asset purchase program were clearly and transparently communicated, including that it was a temporary measure. The credibility of the CNB, supported by

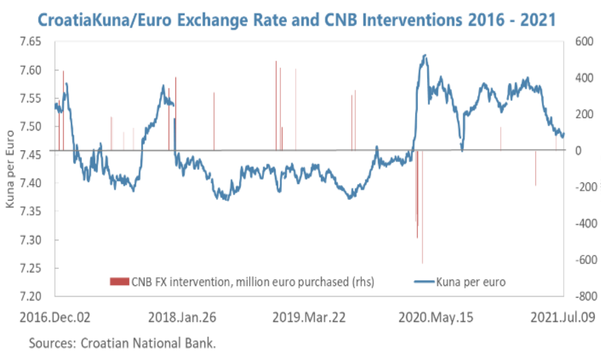
[1] Prepared by Tonny Lybek.

[2] The ERM II intervention band for the kuna is ±15 percent around the central parity of 7.53450 HRV/EUR. There is no intention to change exchange rate policy. Historically, the exchange rate has never come close to these fluctuation levels.

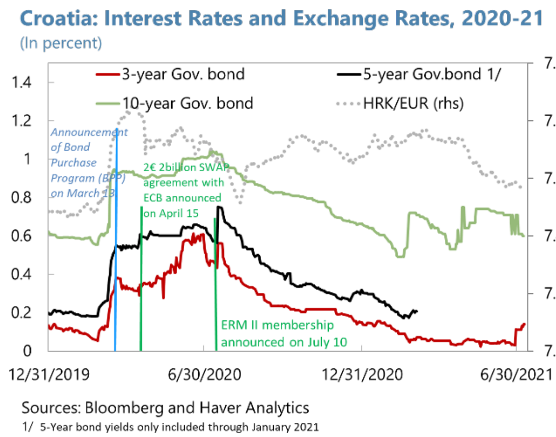
the EU framework against excessive budget deficits, ensured that the potential risk of fiscal dominance never materialized. Since end-June 2020, long bond yields have declined, the spreads vis-à-vis bunds and thus the slope of the Croatian yield curve declined.

Annex Figure IX.1. Croatia: Selected Monetary Policy Indicators of Croatia, 2016–2021

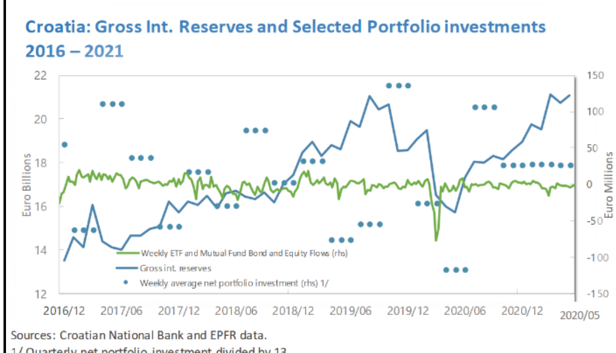
Exchange rate quickly stabilized after the Covid-19 shock.



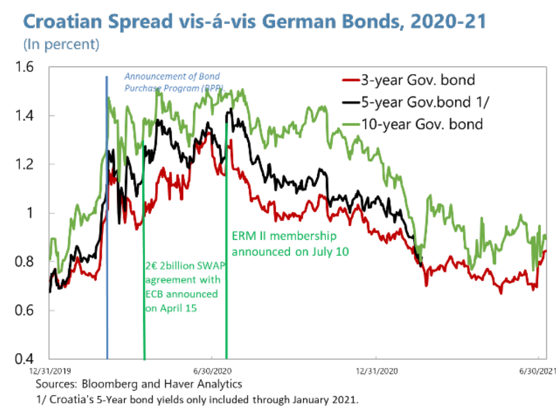
Croatian long bond yields increased at the beginning of the pandemic but have since declined.



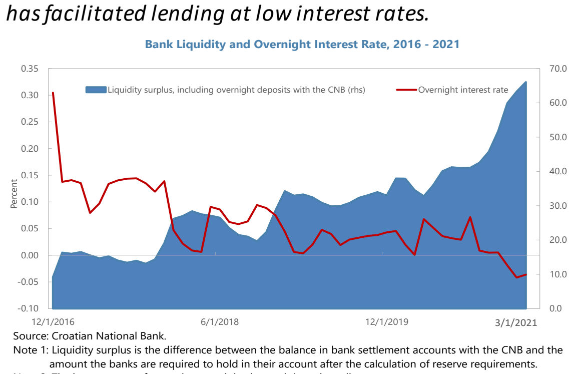
Minor capital outflows at the beginning of the pandemic soon reversed and reserves recuperated.



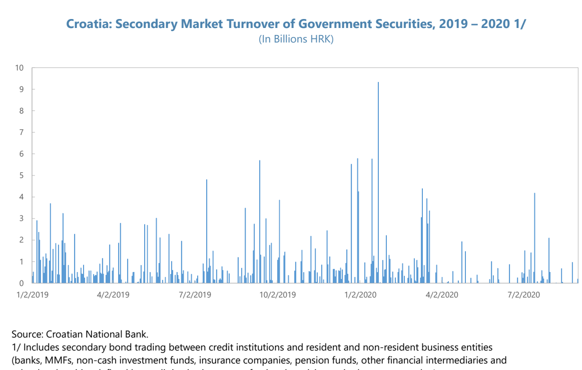
Long-term yields of Croatian government bonds have also declined compared to German bunds.



Record high levels of excess liquidity in the banking system has facilitated lending at low interest rates.



Secondary turnover in government securities reflect the CNB's bond purchase program.



The CNB also lowered reserve requirement and provided liquidity via repos to ensure continued bank lending. In March 2020, the reserve requirement ratio was lowered from 12 to 9 percent, which added about 1.7 percent of GDP in additional liquidity. In addition, the CNB reactivated its long-term (5-year) structural repo facility (1 percent of GDP). Another much smaller auction took place in November. The repo rate for both auctions was 0.25 percent (95 bp lower than the previous auction in December 2018). The original intention of long-term structural repo operations was to ensure long-term kuna liquidity to reduce lending euroization. Finally, some banks temporarily (March 16 to May 11, 2020) used the regular weekly repo, as the CNB lowered the repo rate (from 0.30 to 0.05 percent), but banks have not used it since.

INTERNATIONAL MONETARY FUND

REPUBLIC OF CROATIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 29, 2021

Prepared By	European Department in Consultation with Other Departments

CONTENTS

FUND RELATIONS

(As of June 30, 2021)

Membership Status: Joined: December 14, 1992; Article VIII

General Resources Account:	**SDR Million**	**%Quota**
Quota	717.40	100.00
Fund holdings of currency (Exchange Rate)	717.07	99.95
Reserve Tranche Position	0.35	0.05

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	347.34	100.00
Holdings	305.02	87.82

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Aug 04, 2004	Nov 15, 2006	99.00	0.00
Stand-By	Feb 03, 2003	Apr 02, 2004	105.88	0.00
Stand-By	Mar 19, 2001	May 18, 2002	200.00	0.00

Projected Payments to Fund[1]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2021	2022	2023	2024	2025
Principal					
Charges/Interest	0.01	0.03	0.03	0.03	0.03
Total	0.01	0.03	0.03	0.03	0.03

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement:

In December 1991, Croatia adopted the Croatian dinar as its sole legal tender. The Croatian dinar was replaced by the Croatian kuna on May 30, 1994. The exchange rate of the kuna is determined by supply and demand in the interbank market, with tight management of the kuna-euro exchange rate by the Croatian National Bank (CNB). The *de jure* exchange rate arrangement is a managed float without a predetermined path. Since April 2016, the kuna has stabilized within a 2 percent band against the euro. Accordingly, the de facto exchange rate arrangement is classified as a stabilized arrangement. On July 10, 2020, it was announced that Croatia joined [Exchange Rate Mechanism II], with a central rate of 7.53450 HRV/EUR and with an intervention band of ±15 percent, effective July 13, 2020. The CNB transacts only in euros, U.S. dollars, and SDRs. On June 30, 2021, the official exchange rate was kuna 7.49 per euro (middle rate).

Exchange System:

Croatia has accepted the obligations of Article VIII, Section 2–4 and maintains an exchange system that is free of multiple currency practices and restrictions on payments and transfers for current international transactions, except for restrictions that Croatia maintains solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51). There are no capital account restrictions.

Anti-Money laundering and Financing of Terrorism:

The 5th Anti-Money Laundering Directive of the EU was transposed in 2019. Measures are continuously being made to strengthen enforcement.

Article IV Consultation:

The previous Article IV consultation with Croatia was concluded on February 14, 2020 (IMF Country Report No. 2020/050: Republic of Croatia : 2019 Article IV Consultation-Press Release and Staff Report (imf.org). Croatia is on the 12-month consultation cycle.

FSAP:

An FSAP Update mission took place in October–November 2007. The FSSA Update was published (IMF Country Report No. 160: http://www.imf.org/external/country/hrv/index.htm).

The original FSAP was concluded with the completion of the 2002 Article IV consultation on August 5, 2002, on the basis of missions that took place in April 2001 and September 2001. The FSSA was published (IMF Country Report No. 02/180: http://www.imf.org/external/country/hrv/index.htm).

Technical Assistance 2000–present:[2]

Department	Timing	Purpose
FAD	April 2000	Implementation of Single Treasury Account
	May 2000	Tax Policy
	September 2001	Fiscal Decentralization
	March 2002	Fiscal Management (with STA)
	September 2003–March 2004	A Resident Advisor on Fiscal Reporting
	February 2004	Public Debt Management Program (with World Bank)
	May 2004	Public Expenditure Management
	May 2004	Fiscal ROSC
	April 2005	Review of Indirect Tax Performance and Tax Administration
	June 2006	Regional Public Financial Management (PFM) Advisor
	February–March 2007, July 2008, February–March 2009	Revenue Administration (with World Bank)
	April 2007	Public-Private Partnerships
	May 2007	Tax Policy (with World Bank)
	January–February 2008	Short-Term Expenditure Rationalization
	February 2010	PFM (long-term advisor visit)
	October 2010	Regional expert participation on seminar on Croatian budget management and fiscal policy
	March 2011	Short-term expert visit on Tax Administration Reform
	June 2011	Short-term expert participation at OECD meeting
	June 2012	Options for Modernizing the Property Tax Government Opportunities for Strengthening the Tax Administration (HQ mission)
	October 2012	Short-term expert visit on phasing in a modern Compliance Risk Management Model
	October 2012	Short-term expert visit on improving tax administration governance and organization structures
	April 2013	Public Financial Management: Budget Procedure
	April–May 2013	Fiscal Rules
	June 2013	Strengthening Tax Administration Governance
	December 2014	

[2] Technical assistance during 1992–99 is listed in Annex I of IMF Country Report No. 03/27.

	October 2019	Workshop on Public Expenditure Review (Expert visit) International Public Sector Accounting Standards Gap Analysis and Budgetary Linkages
STA	March 2000	Quarterly National Accounts
	September 2000	Balance of Payments
	October 2000	Real Sector Statistics
	April 2001	Monetary and Banking Statistics
	November 2001	Regional Visit on Reserves Data Template
	October 2002, June 2004	Government Finance Statistics
		Monetary and Financial Statistics
	September 2006	LTE: Government Finance Statistics
	December 2007	
MCM	May–June 2000	Coordination between CNB and the Ministry of Finance, Central Bank Law, Banking Law, and Money and Securities Markets
	March–April 2001	Central Bank Accounting
	December 2001	Monetary Policy Instruments
	April 2003	Stress Testing and FX Reserve Management
		Monetary Policy Instruments
	February 2004	Macro-Financial Modeling and Forecasting
	January 2007–continuing	Macro-Financial Modeling and Forecasting
	May 2007	Modeling and Forecasting
	June 2007	Modeling and Forecasting
	September 2007	FSAP Update
	October 2007	Modeling and Forecasting
	November 2007	Modeling and Forecasting
	March 2008	Macro-Financial Modeling and Forecasting
	August 2008	Macro-Financial Modeling and Forecasting
	February 2009	Macro-Financial Modeling
	July 2009	Monetary Policy and Modeling
	May 2010	Macro-Financial Modeling and Forecasting
	November 2011	Macro-Financial Modeling and Forecasting
	March 2013	Macro-Financial Modeling and Forecasting
LEG	January 2010–April 2011	AML/CFT—Risk based supervision in non-financial sectors
	May 2011–April 2012	AML/CFT—Strengthening the FIU and risk based supervision in non-financial sectors
	December 2011–April 2013	AML/CFT—Preliminary National Risk Assessment

WORLD BANK RELATIONS

Croatia has been collaborating with the World Bank Group.

Further information can be obtained from the following hyperlink.

International Financial Institution	Hyperlink
The World Bank Group	https://www.worldbank.org/en/country/croatia

STATISTICAL ISSUES

Croatia—Statistical Issues (As of June 2021)
I. Assessment of Data Adequacy for Surveillance
General: Data is broadly adequate for surveillance purposes.
National Accounts: The national accounts have strengthened in recent years but further improvement is needed. The Central Bureau of Statistics (CBS) publishes constant and current price data compiled in accordance with the ESA 2010 standard. However, a breakdown of gross fixed capital formation into private and public components is not published as this is not required by the Eurostat. Minor discrepancies exist between nominal government consumption in national accounts and government consumption reported in government ESA 2010 accounts; but they are being resolved.
Wages and Employment: The CBS produces data on average net and gross earnings per person and employment by sector. Currently, the CBS is in the process of reviewing the data series. Earnings data include bonuses (in sums that are subjects to contributions, taxes, and surtaxes), sick pay, and meal allowances. They are based on data from the report on Income, Income Tax and Surtax as well as Contributions for Mandatory Insurances (JOPPD form). The number of registered unemployed overstates the actual level of unemployment. However, the discrepancy has significantly diminished in 2014. A preliminary Labor Force Survey, which meets ILO standards, was conducted for the first time in 1996 on 7,200 households. The sample was subsequently expanded and the survey is now being conducted on a regular basis. Semi-annual results have been released since 1998, and quarterly results since 2007, with a lag of about four months.
Price Statistics: The CBS produces a monthly consumer price index, with expenditure weights (updated at least once in every five years) derived from the Household Budget Survey. Between rebasing, the weights are price-updated annually to December of the previous year. Data are collected at different time periods in the month for different product groups, but in most cases between the thirteenth and the twenty-third day of each month. (Prices of agricultural products sold in market places are recorded on the first and third Friday in a month and prices of fuel for passenger cars weekly.) The indices are released around the fifteenth day of the following month. The price collection is confined to nine towns, but the weights are based on a sample of households in the whole country.

A harmonized index of consumer prices (HICP) is also calculated in line with Eurostat methodology. A core CPI is calculated based on a methodology developed by the Croatian National Bank (CNB). The CBS also releases a monthly producer price index (PPI), usually on the eighth day of the following month. The weighting system of the PPI is based on the 2000 Annual Report of Industry and is changed every five years, while weights are partially corrected every year. A quarterly house price index is also disseminated.

Government Finance Statistics: The authorities have started presenting some budget plans based on the ESA 2010 framework. However, the State Budget and the local budgets are based on the national Chart of Accounts. Historical general government data based on ESA 2010 definitions are published nationally by the Croatian Bureau of Statistics and by Eurostat, but are frequently revised due to methodological and data source improvements. Additional analysis has been initiated in order to assess whether some enterprises owned by local government units should be included in the government sector according to the ESA 2010 criteria.

Budget execution (cash) data are produced on a monthly basis on the GFSM framework (GFS 2001) and are available in the monthly *Statistical Review* of the Ministry of Finance (MOF) and in the time-series database, both published on the website of the MOF. Central government data normally come with a lag of about six weeks, but end-of-year data often with much longer lags. Revenue data are reliable, and expenditure data on a cash basis are available according to GFS classifications (economic and functional) for the central budget and extra-budgetary funds. However, changes of institutions included in the central government are not always clearly indicated, hence central government figures are not fully comparable over time.

Cash data for the operations of local governments and the consolidated general government are available on a quarterly basis, but for end-of-year data with long lags. Starting from the January-March 2015 period, data for local and regional self-government units (local units), instead of former 53 largest, include all 576 local units and the local units' extra-budgetary users - county road administrations.

According to the latest *Agreement on cooperation in the field of national accounts of general government and related statistics* (signed on January 31, 2020 between the Croatian Bureau of Statistics, Croatian National Bank (CNB), and Ministry of Finance), the CNB is responsible for the compilation of general government debt statistics. The CNB is compiling general government debt according to ESA 2010 and EDP definitions and publishes these data on the CNB website. Data showing the level of general government guaranteed debt are presented as a part of the reporting table I.3 on the same website.

Monetary and Financial Statistics: Beginning 2015, the CNB started to publish monetary statistics using the *ESA 2010* framework and the national residency approach, with some backward revisions of historical data series. The IMF's Statistics Department receives monthly monetary statistics on

Croatia for the CNB and other depository corporations (ODCs) directly from the European Central Bank since July 2013, prior to this date, data were reported by the CNB. Data on other financial corporations (OFC), excluding non-money market investment funds, are currently not available.
Financial Sector Surveillance: The CNB is the banking sector supervisor and quarterly reports all core and 14 encouraged financial soundness indicators (FSI) to the IMF's *Financial Soundness Indicator Database*. A general description of the stress testing methodologies used on the Croatian banking system is included in the *Financial Stability Report,* published by the CNB once a year. The Croatian Financial Services Supervisory Agency (HANFA) publishes monthly reports and monthly summary statistics on the sectors it regulates and supervises (capital markets, investment funds, private pension sector, insurance, leasing, and factoring companies).
External Sector Statistics: Quarterly balance of payments and international investment position data are compiled broadly in accordance with the sixth edition of the IMF's *Balance of Payments Manual (BPM6)*. Data are generally available with a lag of three months and are subject to revisions in subsequent releases. Net errors and omissions have ranged from -1 to +3½ percent of GDP since 2005. The coverage and quality of portfolio investment data are reasonably complete and accurate. Croatia participates in the *Coordinated Direct Investment Survey* (CDIS) and plans to participate in the Coordinated Portfolio Investment Survey (CPIS) after the new security database becomes operational. Data on the International Reserves and Foreign Currency Liquidity (Reserve Data Template) are available with a lag of one to two months. Croatia compiles external debt data according to the requirements of *External Debt Statistics: Guide for Compilers and Users, 2013*.

II. Data Standards and Quality	
Croatia began subscription to the Fund's Special Data Dissemination Standard (SDDS) in May 1996 and met all SDDS requirements in March 2001.	No data ROSC has been published. Data are available on the SDDS website of the CNB https://www.hnb.hr/en/statistics/sdds-en

Croatia: Table of Common Indicators Required for Surveillance
(As of July 21, 2021)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
Exchange Rates	07/21/21	07/21/21	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	May. 2021	07/21/21	M	M	M
Reserve/Base Money	May. 2021	07/21/21	M	M	M
Broad Money	May. 2021	07/21/21	M	M	M
Central Bank Balance Sheet	May. 2021	07/21/21	M	M	M
Consolidated Balance Sheet of the Banking System	May. 2021	07/21/21	M	M	M
Interest Rates 2/	May. 2021	07/21/21	M	M	M
Consumer Price Index	Jun. 2021	07/21/21	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/—General Government 4/	2021:Q1	Apr. 2021	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	2021:Q1	Apr. 2021	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	Mar.2021	Jul. 2021	M	M	M
External Current Account Balance	2021:Q1	Jul. 2021	Q	Q	Q
Exports and Imports of Goods and Services	2021:Q1	Jul. 2021	Q	Q	Q
GDP/GNP	2021:Q1	Jul. 2021	Q	Q	Q
Gross External Debt	2021:Q1	Jul. 2021	M	M	M
International Investment Position	2021:Q1	Jul. 2021	Q	Q	Q

1/ Reserve assets that are pledged of otherwise encumbered are specified separately. Data comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means. Gross international reserves are available on a weekly basis on the SDDS website of the CNB.

2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

3/ Foreign, domestic bank, and domestic nonbank financing.

4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

5/ Including currency and maturity composition.

6/ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

Statement by Paul Hilbers, Executive Director for the Republic of Croatia and Darjan Milutinovic, Advisor to the Executive Director
August 30, 2021

On behalf of the Croatian authorities, we thank Mr. Seshadri and his team for the insightful report and the fruitful policy discussions during the Article IV mission. The authorities broadly agree with staff's appraisal and appreciate their valuable policy recommendations.

Amid the pandemic and two large earthquakes, the Croatian economy showed resilience. Although the 2020 economic contraction of 8.0% was one of the largest in Croatian history, it has not been as severe as those experienced by many other economies with an equally strong tourism component. This was mainly due to the swift and ample policy support, including subsidy and job retention schemes, tax relief and deferrals, the opt-in limited time debt service moratorium, and guarantees and grants given to businesses. Thus, the highly expansionary fiscal and monetary policy stance successfully mitigated negative consequences of the pandemic as reflected in the mild effects on the labor market, the stable exchange rate, and the return to pre-pandemic low yields.

EU funds support the authorities' ambitious reform agenda to kickstart a green and digital recovery. The European Commission has recently approved Croatia's National Recovery and Resilience Plan (NRRP), unlocking 12% of GDP of EU grants to be utilized until 2026. 40% of the available funds will be utilized to foster a green transition, 20% for digitalization, and the remainder for reconstruction after the earthquakes, and public administration, labor market and healthcare reforms. Structural reforms complement the authorities' primary strategic priority – the euro adoption, which is planned for the beginning of 2023.

Recent Economic Developments and Outlook

The authorities expect a strong rebound of the economy, driven by an uptick of domestic demand and tourism. After sizeable growth in the second half of 2020, the better-than-expected GDP growth in Q1 2021 and the high-frequency indicators for Q2 point to a robust expansion of the economy in the first half of 2021. Furthermore, recent data show encouraging signs of a recovery in tourism. This would, together with the rebound of private consumption and strong public investment for the reconstruction after the earthquakes, drive the growth rate well above 5% in 2021, higher than the staff forecast. Employment could return to pre-crisis levels without having a lasting impact on inflation. The projected inflation rate of 1.7% reflects an increase in energy prices, with core inflation subdued at around 0.5%.

The authorities forecast a slightly higher growth path over the medium term than that of staff. The macroeconomic impact of the NRRP is assessed to be strongest in 2022 and 2023, adding 1.4 percentage points to the GDP growth each year. As a result, economic activity would intensify and reach the pre-crisis level in 2022 (+6.6%), also supported by continued domestic demand and a recovery in tourism. Growth rates would continue to be solid in 2023 (+4.1%) and 2024 (+3.4%). However, COVID-19 continues to be a downside risk to the outlook in particular because of its negative consequences on tourism.

Fiscal Policy

The robust growth momentum supports the gradual phasing out of policy support. The authorities share staff's view that recovery is a top priority. Therefore, job retention subsidies for vulnerable sectors have been extended to at least till July 2021, in addition to continuing the short-work scheme until the end of 2021. Support measures are conditional upon firms' performance, and, given the dropping number of applicants, the current growth momentum should support their withdrawal. However, if the epidemiological situation worsens, the support will be extended by budget reallocations.

The policy focus would gradually shift from employment support to workers' support. While keeping the targeted support to viable firms, the authorities agree with staff that active labor market policies (ALMPs) have a crucial role in supporting workers' sector reallocation. Therefore, in addition to the current ALMPs, the NRRP would add new measures, including additional skills training.

Tax reforms were aimed at reducing the fiscal burden and boosting economic growth. The 2021 tax changes were the fifth round of the pre-pandemic tax reform package (2017-2019). Tax cuts were mainly directed toward PIT and CIT to reduce the tax wedge and increase private investments, improve incentives to work and support lower-income households. In addition, the tax reform reduced the administrative burden and made the tax administration process more transparent and efficient.

The authorities are strongly committed to medium-term fiscal consolidation. In recent years, the budgetary discipline put public debt on a firm downward trajectory, allowing a sizeable COVID-19 policy response with support from the EU funds. However, an increase in policy support and decreasing fiscal revenues led to a deficit of 7.4% of GDP, with public debt increasing from 72.8% of GDP in 2019 to 88.7% in 2020. However, with the phasing out of support measures and revenues picking up, the authorities expect the deficit to halve in 2021. On the back of the strong growth momentum, public debt would be expected to resume its pre-pandemic downward trajectory reaching 76.8% at end-2024.

Monetary Policy and Financial Stability

The targeted monetary policy response successfully mitigated the negative effects of the pandemic. The CNB introduced a series of monetary policy measures to ensure a stable exchange rate, sustain lending to domestic banks and stabilize the government securities market. The line of FX interventions and the 2 billion EUR swap agreement with the ECB quickly diminished FX pressures at the beginning of the crisis. At the same time, purchases on the secondary government securities market abated the brief market disruptions and contributed to the decline of bond yields. Furthermore, structural repo operations and reduced reserve requirement created additional liquidity that enabled banks to continue lending under favorable financing conditions.

While the CNB continues to pursue highly expansionary monetary policy, the need for exceptional measures has diminished. Short money market rates close to zero, a stable exchange rate, and historically ample liquidity in the banking system imply that large FX interventions and government securities transactions are no longer required. Nevertheless, in case of a significant negative shock, the CNB would deploy appropriately tailored temporary measures.

The banking sector has proven to be stable and sound during the pandemic. The well-capitalized banking sector shows sizable resilience to a severely adverse scenario, as reflected in the outcome of the CNB’s stress testing exercise. Nonetheless, the expected deterioration of credit quality due to expiration of moratoria and the growth of housing loans call for close monitoring. The CNB would reduce excess liquidity in the banking system and use available macroprudential tools, recently enhanced by newly collected granular data on lending, in case of excessive lending or rising housing price imbalances.

The authorities are ready to implement the euro in the beginning of 2023. Croatia joined the ERM II in July 2020, and the convergence criteria for euro adoption are likely to be assessed in mid-July 2022. Notwithstanding the pandemic-caused deterioration of fiscal indicators during 2020, the budget deficit and public debt are set to return to a steady downward path as of this year. Furthermore, as Croatia would satisfy the applicable quantitative convergence criteria, the euro could be introduced as early as 2023. Prior to adoption, the authorities have committed to (i) strengthening the AML framework, (ii) reducing administrative burden for business, (iii) improving SOE governance, and (iv) strengthening the national insolvency and restructuring framework, and the required reforms in these areas are firmly underway.

Structural Policies

The authorities are committed to strengthening administrative capacity for the use of the generous EU funding. With the largest allocation of the NextGen EU grants and regular structural EU funds, Croatia will receive historically high levels of the available EU funds, close to 36% of GDP over the next six years. Therefore, the authorities have recognized the importance of increasing absorption capacity by improving the Public Investment Management (PIMA) with the IMF’s assistance and introducing the Act on the institutional framework for EU funds at end-2021.

The NRRP is introducing steps to improve public sector governance. The public sector salary system will be modernized to become more merit based and mergers of sub-national government entities will be promoted. Regarding the health sector, the authorities plan to tackle the accumulation of arrears by functional integration of hospitals, joint procurement procedure for health institutions and the amendment of the healthcare legal framework. In addition, the NRRP measures would increase social benefits efficiency and pensions adequacy.

Transformation to a green and digital economy is at the heart of the government's economic policy. The green transition consists of substantial investment and a set of measures focused on: (i) buildings renovation, (ii) renewable energy and energy efficiency including investment in electricity, the distribution grid for renewable energy sources, geothermal energy, and geological carbon storage, (iii) waste and water management and (iv) sustainable mobility including investment in rail transport, advanced biofuels, renewable hydrogen, refuel infrastructure, and autonomous vehicles for one of the first capital city with robotaxi services. At the same time, significant digital infrastructure investments are planned in public administration, judiciary, transport, healthcare, and energy sector, together with digital subsidies for firms. In addition, building more sustainable tourism is a key policy focus.

Supported by a favorable political environment, productivity-enhancing reforms allow for Croatia’s rapid convergence to EU levels. Educational reforms, parafiscal charges and a reduction of regulatory constraints, a reduction in the duration of court proceedings and case backlogs in the judiciary, and measures to support investment in science, R&D, and innovation would all lift the potential growth. The authorities are keen to front-load a significant share of the reforms over the next three years to deliver on the comprehensive reform agenda.